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Diverging Developmental Pathways on the Margins of the EU

The Case of the Hungarian and Polish Dairy Sectors

David G. Karas

Thesis submitted for assessment with a view to
obtaining the degree of Doctor of Political and Social Sciences
of the European University Institute

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European University Institute
Department of Political and Social Sciences

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Abstract

This thesis seeks to understand why similar semi-peripheral developing economies might benefit differently from transnational market integration. It wishes to establish a dialogue with a current debate, marked by very different interpretations regarding the economic and developmental performance of Central and Eastern European (CEE) countries. It argues that from similar starting positions, individual sectors in CEE economies could follow widely different modes of transnationalization in sectors where access to technology was cheap – yet domestic actors needed to secure capital, which neither the state nor domestic private banking sectors could offer them. Contrary to technology-intensive sectors where proprietary technologies might “force” developing economies to adopt an integrationist strategy relying on MNCs to secure financial assets and technology, in less technology-intensive sectors, different pathways of transnationalization remained open, yielding different developmental outcomes. For illustrating this argument, the thesis uses the case of the dairy sector’s post-Socialist restructuring in Hungary and Poland: Hungary experienced the developmental failure of an integrationist strategy, while Poland illustrates the unforeseen benefits of an autonomist pathway. The thesis argues that different policy choices in the two countries reflected differences in the resources and organization of state and non-state actors, the types of linkages tying them, and different institutional legacies stretching back to the Socialist period. In so doing, it seeks to show that even for small and open economies, the diversity of developmental pathways is substantially wider than usually assumed: neither too deterministic theories such as dependent underdevelopment, nor too general typologies such as the Varieties of Capitalism framework can grasp the actual diversity of developmental experiences, which exist at a sector level, especially in less technology-intensive sectors where a wide scope for variation exists. On the other hand, this thesis also shows that particular modes of transnationalization can also be abandoned for alternative strategies when they fail to secure tangible benefits to domestic actors. Modes of transnationalization for developing economies are more diverse but also more transient than often assumed.

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Introduction

The present thesis is a study of diverging developmental outcomes produced by different modes of transnational market integration in the context of post-Socialist transition economies in the Central Eastern European (CEE) region. The complex challenge of transforming authoritarian one-party regimes characterized by command economies set the region apart from counterparts in the “Global South” where the task of democratizing politics could at least build on pre-existing market economies (Offe, 2004). Industrial productive capacities built during the Socialist period and a centralized public administration equally distinguished these countries from LDCs where neither the basic Weberian administrative capacities of the state, nor an industrial infrastructure had been established before they joined transnational markets. In spite of these advantages, when state Socialism collapsed in the region in 1989-1991, integrating CEE into regional and global markets posed fundamental challenges in transforming them into viable market economies, which wouldn't simply collapse under free market conditions.

For these reasons, CEE became an ideal case study for the students of capitalism as an open laboratory in market building strategies. One research agenda used CEE transition for studying the complex re-combinations of particular domestic institutional legacies in a new opportunity structure (Stark & Bruszt, 1998): Already by the mid 1990s, these authors were puzzled by the degree of intra-regional variation in post-Communist economies' emerging institutional structures. Another scholarship studied institutional re-configurations from the perspective of the Varieties of Capitalism (VoC) literature pioneered by Peter Hall and David Soskice (Hall & Soskice, 2001). The recent work of Bohle and Greskovits (2012) proposed to extend the VoC tradition's focus on institutional complementarities determining particular comparative advantages with a Polanyian approach to market-society relations. In spite of substantial differences in their theoretical frameworks, these approaches converged in a shared attempt at identifying particular sub-regional institutional patterns of post-Socialist economies.

A more recent research agenda has begun investigating the developmental consequences of post-Communist restructuring and transnationalization. Bruszt and McDermott (2014) studied the distributional problems of transnationalization in what they called different Transnational Integration Regimes (TIRs) – in their framework, CEE was used as a case study for examining the specific advantages and limitations of an integration project fundamentally tied with the process of economic and regulatory integration with the EU's common market - in light of the gravitational pull that this regional hegemon exerted on CEE. In parallel, Scepanovic's recent work examined the developmental benefits and pitfalls of transnationalization through FDI and the role of multinational companies (MNCs) as potential agents of competitive upgrading in CEE economies (Scepanovic, 2013).

We place the present thesis in the continuity of these latter research agendas, focusing on the developmental consequences of different modes of transnationalization that emerged in the CEE region. However, the abovementioned literatures have put a stronger emphasis on the role of external public (EU) and private actors (MNCs) in shaping regional varieties of capitalism: in that sense, CEE was used as a case study for uncovering the developmental impacts of transnational actors. Bruszt and Langbein (2014) examined the extent to which the EU functioned as an agent of economic upgrading in specific domestic contexts, while Scepanovic (2013) studied how MNC car manufacturers contributed to economic modernization in the region. We propose to examine the other facet of this problem, namely the differentiated role played by domestic agency in shaping developmental outcomes in these deeply transnationalized semi-peripheral economies. In so doing, we also hope to establish a dialogue with a larger research question far overstretching the confines of CEE, that is the room left for developmental public agency in peripheral and semi-peripheral economies in a globalized world economy (H. J. Chang, 2006).

We propose to examine how domestic actors in Hungary and Poland - two CEE countries often considered as most similar cases in light of their macroeconomic institutional features¹ – actively shaped their own modes of transnationalization into regional and

¹ Bohle and Greskovits group them together notably in light of a similar heritage in implementing market-friendly reforms under Socialism based on the "Welfarist social contract" concluded between state and

global markets in remarkably distinct ways at the sector level – leading to very different consequences for their sector’s overall economic competitiveness as well as different distributions of benefits between domestic and foreign actors. We examine this process of developmental divergence through the comparative case studies of Polish and Hungarian dairy sectors’ restructuring in the post-1989 period.

By contrasting two similar countries, which had to confront the same fundamental challenges of post-Socialist restructuring with comparable resources, we seek to shed light on how radically different were the strategies, which domestic actors embraced in managing the transnational integration of a particular sector to regional and global markets.

As with any case selection, the milk and dairy sector offers a number of advantages and drawbacks. Agri-food processing represents a strategic sector in the EU: it is the biggest industrial sector and the third largest employer with 2,6 million employees (van der Meulen & van der Velde, 2006, p.561), while it is also of strategic importance for food security. The dairy sector relies on a complex coordination between three distinct segments in the supply chain: the production of milk at farm level, the transformation of milk into processed goods at processing plants and the sale of end products in retail. As such it offers potentially rich lessons in different institutional solutions to vertical coordination along the supply chain. Furthermore, in light of the food security crises experienced in Europe throughout the 1990s, agri-food sectors are among the most tightly regulated industries in the EU where stringent public and private production and product standards regulate the sector. Given important adaptation costs entailed by food safety standards, economic upgrading in the sector required substantial capital investments throughout the transition phase as well as importing modern, and more productive technologies than what either country disposed of in 1989.

society in the post-Socialist period (Bohle & Greskovits, 2012p.141). The VoC framework considers them similar in light of their comparative advantage in the assembly of semi-standardized industrial goods (Nolke & Vlieghenart, 2009).

In that regard, the challenge of restructuring dairy sectors reflected a basic problem common to all late-industrializers: the need to secure capital and technology in a domestic context where both assets were rare. Unlike more technology-intensive sectors such as electronics or automotive however, accessing proprietary technology wasn't as important as securing the financial capital necessary for modernizing domestic capacities: in other words, as technology could be purchased, dairy offered a wider room for different strategies aimed at securing financial capital². Although this specificity might be considered a disadvantage, we argue that it has also benefits from a theoretical perspective: In a sector such as dairy, in spite of the highly disadvantageous and poorly competitive situation characterizing both the Polish and the Hungarian sectors at the onset of transition, there was no clear limit as to how far these countries could potentially strengthen their competitiveness on domestic and export markets... neither was it clear how deep they could fall.

Restructuring these sectors was not only a question of economic modernization, but it also represented a distributive problem: Elizabeth Dunn (2003) was among the first authors to underline that since EU integration required regulatory harmonization with modern food safety standards, the question soon turned into how many and which domestic actors could access the capital (and technologies) necessary for regulatory compliance and for withstanding competition. In other words: who counts, and who gets to survive (Bruszt & Stark, 2003)?

In this developmental conundrum, the state had a crucial role in arbitrating between economic and social priorities, with potentially highly skewed outcomes. Thus, by studying different domestic policy choices within a highly standardized industrial sector, one can shed light on the scope left for differentiated developmental public agency even within a particularly constrained environment. Furthermore, the dairy sector has already fuelled interest among the students of post-Communist market making: Bruszt and Langbein (2014) used the sector for demonstrating how the EU's pre-accession agenda of regulatory harmonization contributed to inserting the Romanian and Polish dairy sectors in different positions within the EU market. Another group of authors led

² As discussed later, more technology-intensive sectors often rely on proprietary technologies and patents controlled by MNCs: in dairy however, technology embedded in machinery can be purchased.

by Johan Swinnen argued that the dairy sector in CEE exemplified the positive developmental role played by foreign capital in the transition phase (Dries, Germenji, Noev, & Swinnen, 2009; Dries & Swinnen, 2002, 2005; Dries & Swinnen, 2010; H. Gow, D. H. Streeter, & J. F. M. Swinnen, 2000; Gow & Swinnen, 1998; H. R. Gow, D. H. Streeter, & J. F. M. Swinnen, 2000; Johan F.M. Swinnen, Dries, Noev, & Germenji, 2006; J. F. M. Swinnen & Maertens, 2007). We would argue on the other hand that diverging developmental outcomes observed at the sector level in Poland and Hungary offer a graphic illustration of a substantial room for variation in domestic developmental objectives, sustained by different actor coalitions.

Against this background, this thesis seeks to answer the following questions: what explains that two comparable economies such as Hungary and Poland, faced with similar constraints, nonetheless experienced dramatically different outcomes, namely a competitive downgrading in Hungary, while Poland became one of the world's foremost dairy exporters? Furthermore, why did restructuring marginalize domestic farmers and processors in Hungary, while domestically owned cooperatives inherited from state Socialism became the key winners of restructuring in Poland?

We argue that the two sectors' specific modes of transnationalization was determined by domestic state and non state actors: in Poland and Hungary, domestic variables explain substantially better the diverging developmental pathways of the two sectors than differentiated strategies of transnational public and private actors. In turn, these modes of transnationalization fared very differently from a developmental perspective.

The relatively simple most-similar-case design allows for a process tracing methodology, which can identify how actors faced with similar constraints chose different strategies for altering their conditions: Drawing on a long tradition of developmental studies starting with Albert O. Hirschman (1958), Cardoso and Faletto (1979) and Peter Evans (1979), the dissertation is led by the idea that while structures shape opportunity structures, they do not determine outcomes – ultimately, only actors do. Based on this insight, the dissertation examines how actors have shaped the structures that they inherited and how these choices in turn produced two diverging developmental pathways.

The thesis is structured as follows: In the first chapter, we provide a critical overview of the extant political economy literatures on CEE transition in their attempt at conceptualizing developmental outcomes and pathways. We define developmental outcomes along two axes: economic upgrading and the capacity for domestic private actors to benefit from market liberalization and transnational market integration. In the second chapter, we review the competing hypotheses in the current literatures as to which independent variables could best explain variation in developmental outcomes and pathways: we propose a theoretically grounded argument for understanding how differences in the sector-level organization of public and private actors, as well as their linkages have led to diverging policy choices yielding different developmental outcomes. In the third and fourth chapters, we provide an empirical analysis of the two case studies – respectively Hungary and Poland’s dairy sectors over the course of post-Communist restructuring and EU accession. Finally, we clarify how domestic developmental coalitions co-evolved with domestic institutional structures, shaping particular contexts in which transnational actors were embedded differently.

Chapter 1

This thesis explores the developmental consequences of market liberalization and transnational integration in semi-peripheral Central Eastern European (CEE) economies. It seeks to understand why the post-Socialist restructuring of an agri-food sector such as dairy shows dramatically different outcomes in terms of competitiveness and inclusiveness for domestic actors in Hungary and Poland, two CEE economies consistently classified as most similar cases. Hungary and Poland's post-Socialist economies have entered transnational markets in a similar opportunity structure in the 1990s: they have been classified together as core cases of a Visegrad sub-regional model of capitalism (Nolke & Vliegenhart, 2009). On closer inspection however, in a given sector such as dairy, one observes symmetrically opposite trajectories: a successful insertion of the sector with broad based benefits for domestic actors in Poland, and a gradual collapse of competitiveness in Hungary alongside a marginalization of domestic actors.

From the perspective of peripheral and semi-peripheral economies, integrating transnational markets and transnational regulatory regimes is a necessity few can resist: The gradual demise of protected national markets has spurred a variety of pathways to transnationalization ranging from bi- or multi- lateral trade agreements to regional common market areas or the integration of domestic sectors into the global supply chains (GVCs) of MNCs (Baldwin, Martin, & Ottaviano, 2001). While transnational integration might be inescapable, from the perspective of domestic public and private actors in the global periphery and semi-periphery, what matters is how their specific pathways of transnationalization affect their developmental trajectories. More than a question of trade, transnational integration is thus fundamentally a developmental problem, which underscores the necessity for a theoretical and methodological framework able to define and compare developmental outcomes.

In light of these, it is surprising that important gaps remain in the extant literatures on the diversity in developmental performance of different modes of transnationalization in the global periphery. CEE, one of the best-studied semi-peripheral regions, exemplifies these contradictions. There is a lack of consensus for assessing

developmental outcomes in post-Socialist CEE: some view the region as a prime example of successful insertion into global markets and a regional integration project steered by the EU, while others speak of the region's colonial exploitation by Western public and private actors. These debates are rooted in a disagreement over the indicators and methods for operationalizing "developmental pathways" and "developmental performance" in global markets.

The present chapter provides an overview of the literatures, which offered methodological guidelines for comparing the developmental consequences of transnational integration in CEE and it provides a framework that is better suited for capturing the puzzle of divergent developmental outcomes in similar economies: specifically, we argue that developmental trajectories ought to be captured not only in reference to a given sector's changing position in regional and global markets, but also crucially, the position of domestic actors (producers and firms) should be re-evaluated: Sidelining the question of ownership and, *inter alia*, the distribution of benefits - ignores the actual economic and social consequences of transnational integration for domestic actors.

The first section of this chapter positions CEE in the broader literature on developmental strategies in peripheral and semi-peripheral economies. A second part highlights the advantages and drawbacks of the methodologies offered by the extant scholarships in defining developmental outcomes in CEE. In a third part, an alternative framework is proposed, where a domestic sector's performance in regional and global markets, and the relative position of domestic actors comprise two dimensions of developmental outcomes. Finally, the case of Polish and Hungarian divergence at the sector level is located in this framework.

Part 1. Specificities of CEE in the wider literature on developmental strategies in the periphery

The post-Communist restructuring of the CEE region offered an unprecedented opportunity for the students of new modes of transnationalization given the particular experience of the region in the 1990s and 2000s: not only were market economies

created *ex nihilo*, but contrary to “autonomist” developmental strategies reigning in the global South until the 1980s, CEE became one of the most deeply transnationalized regions of the world.

Although a vast literature on economic development bloomed after the Second World War and subsequent decolonization waves, the objects of these studies were mainly South-East Asian and Latin American countries that experimented with varieties of economic *dirigisme*, relying on a strong and relatively competent and autonomous state to implement sector-level national plans in order to catch up with Western levels of growth and competitiveness (Amsden, 1989, 2001; Evans, 1979; Johnson, 1989). Following the terminology used by Alice Amsden (2001), countries ranging from Brazil to South Korea can be understood as varieties of an *autonomist* form of developmentalism aimed at building entire supply chains at the domestic level in strategic industrial sectors identified by the state: while the goal was similar, differences between Latin-American and South-East Asian countries concerned the instruments of public interventionism where import tariffs, export subsidies and relations between public administrations and the private sector were articulated differently.

By contrast, the process of post-Communist transition in CEE followed a fundamentally different route: The challenge for these countries was on the contrary to dismantle national conglomerates and reduce public ownership as much as the state’s institutions of economic mobilization and coordination in a global environment that actively discouraged these countries from using the state as the prime agent of development. The widespread consensus among both CEE elites and those international financial institutions (IFIs) and international organizations (IOs) that played an active role in the process (such as the World Bank, BERD, the IMF and the EU) - was to keep as little public influence over markets as possible. Three factors single out the CEE experience from previous modes of transnationalization in other semi-peripheral regions: The timing of the transition and restructuring processes, the role played by foreign capital in post-Socialist restructuring and the EU as a regional hegemon.

Timing

From a constructivist perspective, the paradigmatic shift represented by the neoliberal turn came close to a hegemonic ideology by the end of the 1980s in Western Europe and the United States. In the early 1990s when CEE states needed models as well as political and economic assistance in restructuring their economies, the dominant view favored a dramatic downscaling of public interventionism in the marketplace – an argument that received a warm reception among CEE elites that had been increasingly concerned over unsustainable levels of foreign debt and the burden of costly public subsidization schemes on state budgets throughout the last decades of state Socialism (Aligica & Evans, 2009).

Second, the world economy in which post-War developmental states thrived in the Global South had been displaced by a qualitatively different system by the time CEE embarked on post-Socialist transition. By the 1990s, due to the gradual reduction of tariffs and the liberalization of transnational capital flows spearheaded by GATT and later the WTO, MNCs de-territorialized the world economy by establishing global production chains where individual production stages were relocated to countries that enjoyed a comparative advantage in any given production segment. For developing economies, a new challenge arose: either to pursue a developmental strategy that aimed at building entire domestic supply chains from scratch (*autonomism*), or to integrate the global supply chains of MNCs (*integrationism*). As pointed out by Richard Baldwin, by the 1980s it was virtually impossible for late-industrializers to sustain the “classical” *dirigiste* developmental recipe: not only because building up entire industrial sectors had always been a hazardous endeavor that could easily derail but because the virtually cost-free strategy of integrating MNC supply chains offered immediate jobs and a secure outlet for domestic production in the form of soaring export levels overnight (Baldwin, 2013) . The second crucial difference with the preceding decades was rooted in the reluctance of private creditors and IFIs to continue financing the appetite of emerging economies for the foreign capital necessary to finance ambitious industrialization programs: in the aftermath of the 1982 debt crisis that spread from Latin America, state-managed industrialization plans financed with foreign debt in protected sectors were consensually rejected by foreign creditors. In such a context, which Baldwin calls the

“second unbundling of the world economy”, late-industrializers had temporal constraints that didn’t allow them to experiment the lengthy trial and error phase previously enjoyed by Korea or Japan since they were in immediate competition on world markets with countries that followed the alternative model of “overnight industrialization” through foreign direct investments (FDI) by MNCs. On the other hand, their ability to raise capital through the traditional channel of foreign debt was compromised. By the time CEE was faced with the task of building functional market economies, an “integrationist” developmental alternative (Amsden 2001, p.271) offered clear advantages and paved the way for an unprecedented flow of FDI to the region.

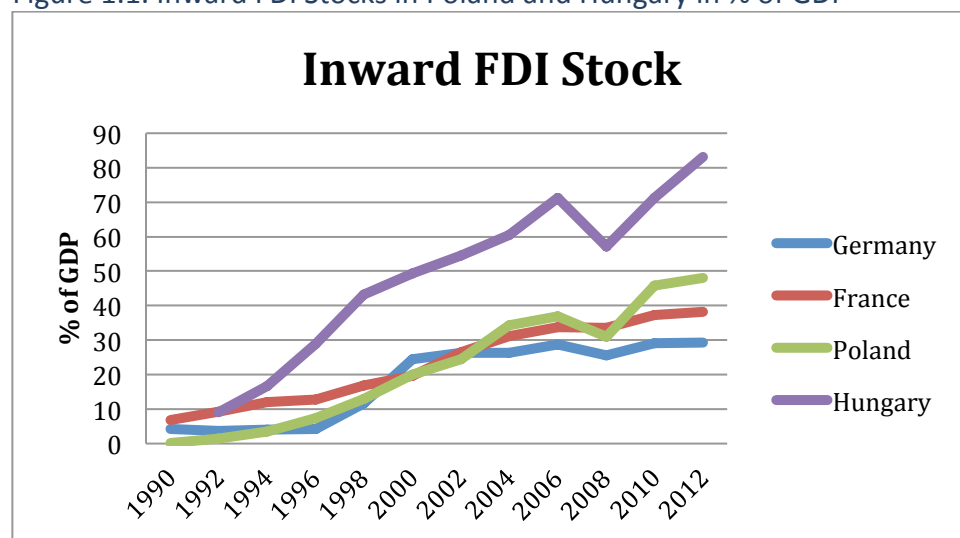
Foreign Capital

As mentioned before, the Zeitgeist of the 1990s favored neoliberal developmental strategies. International donor organizations such as the World Bank and the IMF rolled back on their support to autonomist strategies and instead favored export-oriented, *integrationist* industrialization: rather than insulating emerging domestic sectors, liberalizing domestic markets through trade became a commendable strategy (World_Bank, 1979, pp. 27-28). In the face of a structural lack of domestic capital to purchase Socialist assets and weakly capitalized domestic banking sectors - a situation Szelényi et al. called a “capitalism without capitalists” (Eyal, Szelényi, & Townsley, 1998) - it became apparent in the first years of the transition period that brown- or greenfield foreign investments (FDI) would play a central role in the adaptation of Socialist firms to the market economy. With the partial exception of Slovenia, and important variations between sectors, foreign ownership of productive assets became a distinguishing feature of CEE varieties of capitalism setting the region apart from Western European forms of capitalism.

The prominence of FDI in CEE economies was not only different from the experience of Asian and Latin American developmental states but it also set the region apart from Western Europe. Ironically, the dual process of economic and regulatory integration to transnational markets and the parallel process of EU integration - in actual fact entrenched a model of capitalism different from Western Europe (Bruszt, 2002): CEE became a region where foreign ownership of economic assets and external political

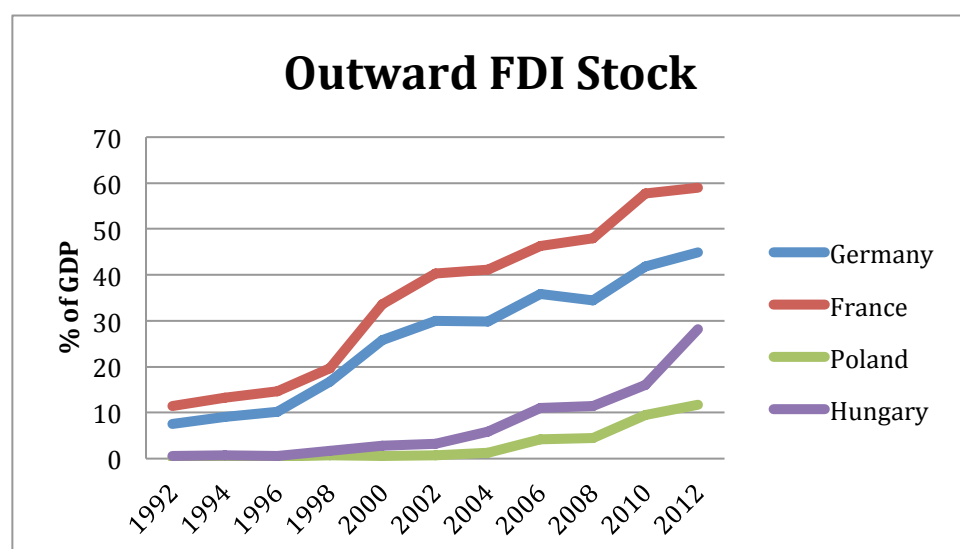
norms played an important role in steering the direction of institutional change with a severely reduced margin of manoeuvre left to elected officials. Conversely, CEE exports substantially less capital than Western Europe, which marks an asymmetrical integration to regional and global financial and trade markets as illustrated below with the examples of Poland and Hungary.

Figure 1.1. Inward FDI Stocks in Poland and Hungary in % of GDP



Source: OECD

Figure 1.2. Outward FDI Stock in Poland and Hungary in % of GDP

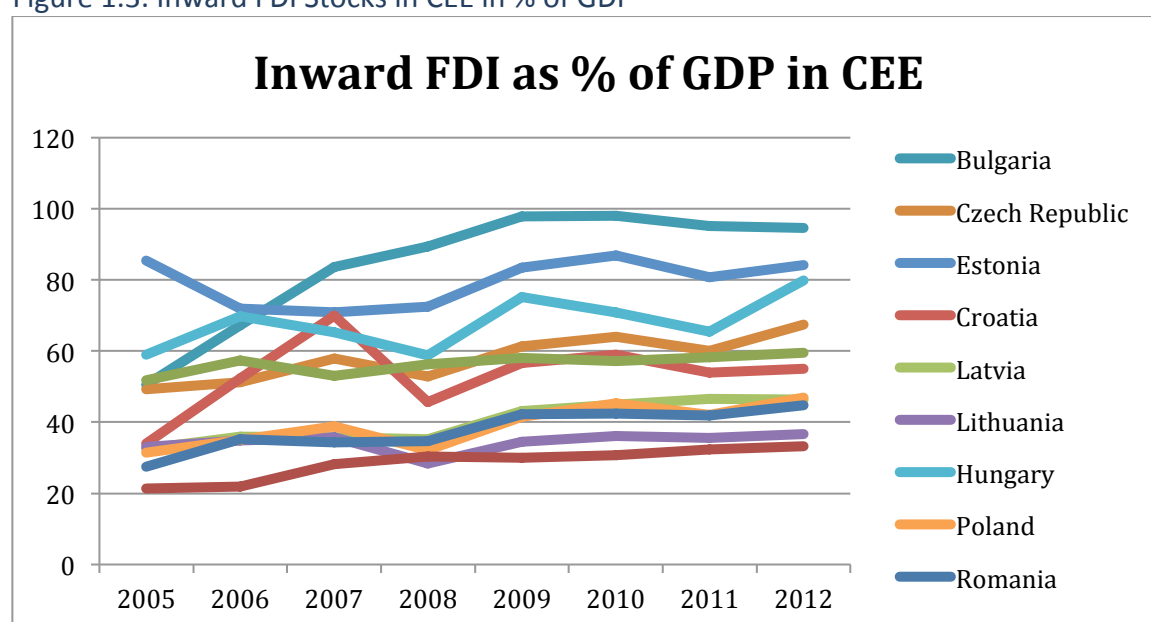


Source: OECD

The reliance of CEE states on FDI in particular has led the students of CEE varieties of capitalism to label them as “dependent market economies” (Nolke & Vlieghe, 2009),

structurally different from “core” capitalist models. However, while FDI indisputably played a crucial role throughout the region at the macro level, this thesis argues that the extant literatures often underplay important differences in how CEE states managed the penetration of their domestic markets by MNCs. The actual heterogeneity of FDI penetration between CEE countries is apparent at a macro level as shown in figure 1.3. but further differences can be identified at sector levels even between countries clustered in the same sub-regional models, as the following chapters will show. Briefly put, CEE “dependent market economies” actually encompass different modes of transnational integration where foreign capital was embedded differently into domestic economies.

Figure 1.3. Inward FDI Stocks in CEE in % of GDP



Source: Eurostat

EU Integration

The third specific feature of CEE transnationalization lay with the key role of the EU in steering domestic institutional change on an unprecedented scale compared with multilateral assistance and capacity building programs in other developing countries. The EU’s use of membership conditionality constituted a powerful leverage mechanism that incentivized regulatory harmonization in CEE with the EU *acquis*. In contrast to

previous enlargement waves, the EU equally engaged in direct institution-building and implemented new pre-accession assistance programs (Bruszt & Holzacker, 2009).

The EU defined developmental goals vis a vis CEE essentially negatively: Bruszt and Vukov argue that the experience of German reunification had sensitized the Commission against the potential costs of an overall collapse of domestic industries. Therefore, the primary aim of the EU was to build up a sufficient degree of competitiveness in CEE, which could weather the shock of foreign competition within the Common Market: the Copenhagen criteria for EU accession accepted in 1993 coined it as the “capacity to withstand competitive pressure” (Bruszt & Vukov, 2014). The EU used a complex set of tools to “manage” CEE transition: regular monitoring through annual “progress reports” measured the pace of regulatory harmonization, while targeted assistance took the shape of capital transfers under pre-accession funds such as PHARE or SAPARD as well as administrative training programs for bureaucrats such as TAIEX or so-called Twinnings (Bruszt & McDermott, 2014a). Another type of intervention consisted in the selective empowerment of domestic target groups such as advocacy coalitions, NGOs, which had incentives to deepen regulatory harmonization in fields such as human rights or environmental standards (Andonova, 2004; Grabbe, 2006; Hughes, Sasse, & Gordon, 2004; Vachudová, 2005). Oftentimes, such groups acted as the domestic counterparts to the EU’s external conditionality system by forming advocacy networks that pressured the state to accelerate regulatory harmonization and compliance with EU norms in specific issue areas where they enjoyed a tangible benefit from EU accession: such benefits were not primarily financial but could be measured in terms of reputation, prestige and influence both on domestic policy making and within transnational European networks of NGOs and experts (Andonova & Tuta, 2014). As such, NGOs often played the role of domestic watchdogs of EU law enforcement, partially offsetting the cost of monitoring from the shoulders of the Commission. In spite of these, the EU’s “developmental” concern regarding CEE restructuring was defined largely negatively – in a minimalist form, to avoid a costly economic collapse. The EU had no clear positive developmental agenda for CEE: the EU Commission had no roadmap for defining specific pathways of transnationalization, neither did it have measurable objectives regarding the region’s catching up with EU15 economies.

Part 2. Measuring and Assessing Development in CEE

We have so far remained elusive as to what precisely constitute “developmental outcomes”. It is now time to spell out that there is a fundamental lack of consensus in the extant literatures on the political economy of post-Socialist CEE restructuring for operationalizing indicators of economic development – consequently, there are equally large gaps between widely different normative assessments of the region’s developmental *performance* in light of the measures used by various camps. What structures the debates however is the theme of catching up – whether and to what extent CEE economies converge to- or diverge from- Western European economies. The capacity of late industrializers to catch-up with rich industrialized economies has been a central research theme since Gerschenkron’s seminal work on economic backwardness (Gerschenkron, 1962). It is thus hardly surprising that post-Socialist development in CEE has been framed in relational terms vis a vis Western European economies. Broadly speaking, three positions can be identified: A first group of authors posit that their indicators show a gradual convergence of CEE economies to Western European standards. For a second group of authors, CEE is on the contrary an example of dependent underdevelopment. Finally, a cautiously pessimistic third camp argues that their evidence points to temporary gains in competitiveness without actual convergence.

Successful Catching Up?

For a first group of authors, CEE restructuring has been largely positive in spite of widespread pessimism in the early 1990s. Operationalizing developmental trajectories in this view typically rests with comparing GDP growth levels and GDP per capita. In a 2009 study commissioned by the EU Commission regarding the economic effects of EU integration for CEE, the authors of the report argued that *“The econometric test of economic growth determinants shows that four variables related to the EU enlargement: FDI inflow, economic freedom, progress of structural reforms, and aid inflow, are positively and significantly correlated with GDP growth rates in the CEE countries” (...)* *“The results indicate that the EU enlargement significantly contributed to economic growth of the CEE-10 countries (...) There has been a clear-cut income-level convergence between the CEE-10*

countries and the EU-15. The former grew on average faster than the latter during 1996-2007 while their initial income level was much lower. Moreover, the convergence process accelerated after 2000 as the EU enlargement approached” (Rapacki & Prochniak, 2009). Based on this trend, the authors are confident enough to propose precise timeframes for the developmental catching-up of EU10 with EU15 countries in the table below, as they argue: “According to our projections, the actual process of convergence between individual CEE-10 countries and the EU15 may take between 8 and 33 years” (Rapacki & Prochniak, 2009, p.19).

Table 1.1. CEE’s Catching-Up Scenarios with EU15 Economies

Country	1996 development gap (GDP per capita in PPP, % of EU-15 average)	Average annual growth rate of real GDP per capita (1997-2008) ^a	2008 development gap (GDP per capita in PPP, % of EU-15 average)	Expected time to catch up by a CEE-10 country with the EU-15 average development level – base case	Revised average annual growth rate of real GDP per capita (1997-2008 and forecast for 2009-10)	Expected time to catch up by a CEE-10 country with the EU-15 average development level – revised scenario
Bulgaria	25	5.1	35.6	32.9	5.1	30.4
Czech Republic	65	3.1	73.9	23.4	3.2	18.8
Estonia	33	7.1	61.0	9.7	6.2	11.1
Hungary	44	4.0	56.4	26.5	3.6	28.1
Latvia	28	8.0	50.4	11.5	6.8	13.6
Lithuania	31	7.3	55.6	11.1	6.2	13.1
Poland	39	4.4	50.1	27.6	4.3	25.5
Romania	23 ¹	6.5 ²	38.5	20.2	6.2 ³	19.9
Slovak Republic	43	5.1	64.0	14.1	5.1	13.0
Slovenia	66	4.2	82.4	8.2	4.1	7.9
EU-15	100	1.8	100.0	x	1.6	x

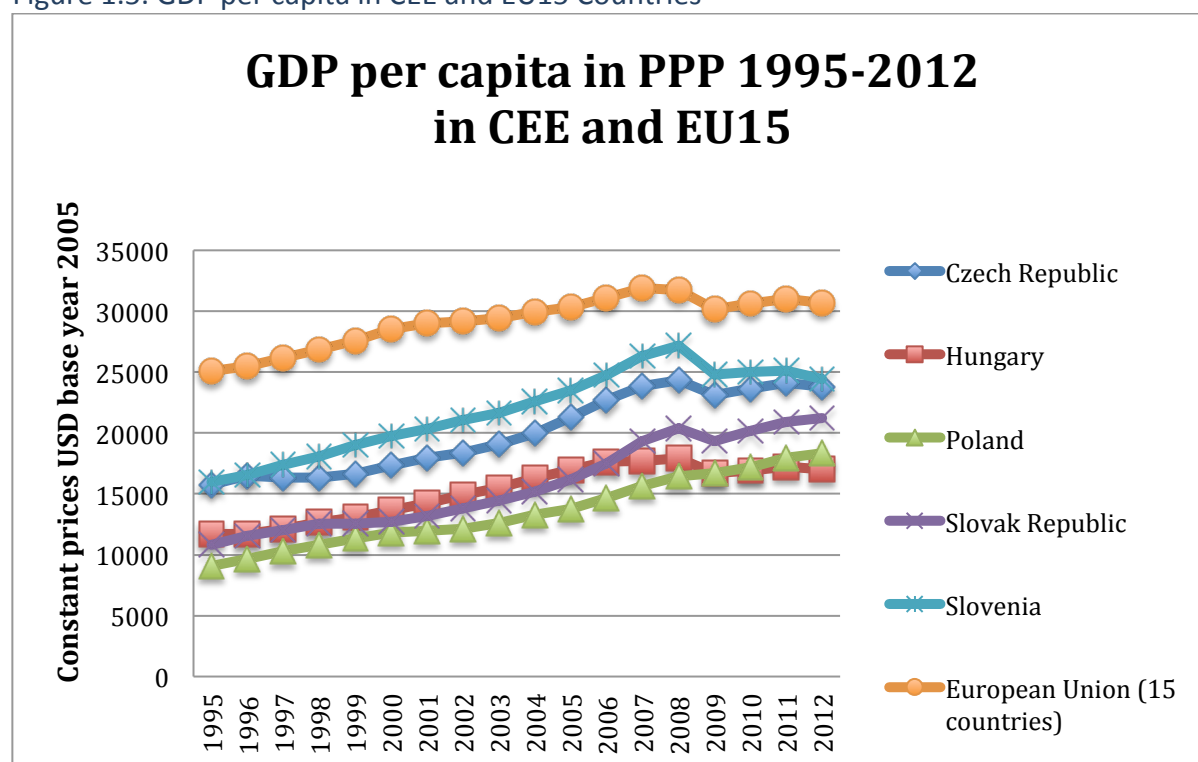
a – data for 2008 are the most recent Eurostat forecasts (as of mid-December 2008).

1 – 1999, 2 – 2000-2008, 3 – 2000-2010.

Source: (Rapacki & Prochniak, 2009, p.20)

The long-term performance of the region seems to support the claim of catching-up between CEE and EU15 countries: In 1994, CEE’s average GDP per capita amounted to 50% of that of EU15 countries while by 2012, it had increased to 68% (see figure 1.5).

Figure 1.5. GDP per capita in CEE and EU15 Countries



Source: OECD

However, there are strong reasons for remaining critical of a convergence hypothesis between CEE and EU15 – as perceived through an equalization of growth rates and GDP per capita indicators. Dunford and Smith (2000) showed that these approaches are both theoretically and empirically misguided: at the theoretical level, these models rely on the assumption of exogenous technological change freely available and transferable between economies. If restricted access to technology is eliminated, such models predict convergence because neoclassical production functions assume diminishing returns to capital over time and constant returns to scale: a smaller stock of capital such as in CEE is thus “bound” to produce higher productivity growth than richer EU15 countries – leading to long-term convergence. The first problem is that technological change and human capital could well be endogenously produced, thus compensating for diminishing returns on capital as argued by more recent theories of endogenous growth (D. Acemoglu, 2009) – in which case late industrializers such as CEE with a lower stock of human capital and access to technology would be at a structural disadvantage compared with EU15 economies’ spillovers and feedback loops between investments in human capital, technological progress and high productivity. The crux of the problem concerns

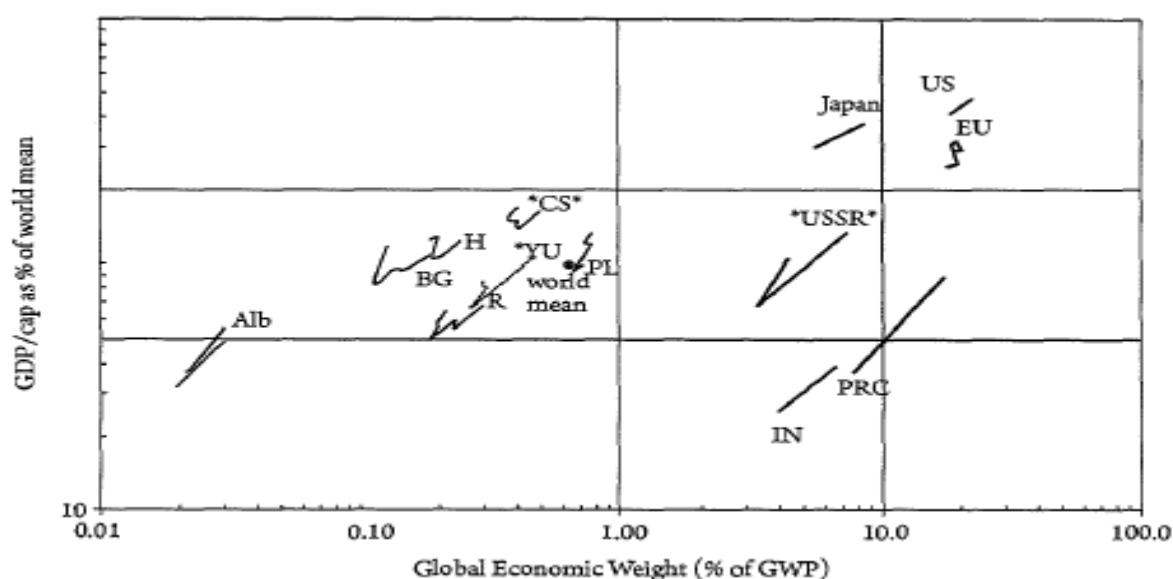
access to technology, which is empirically limited by ever more stringent intellectual property rights protection regimes. Duncan and Smith add that nothing substantiates the assumption that EU15 and CEE countries would be converging on the same long-term growth rates. On the contrary, they find that strong economic inequalities remain between the two groups of countries – with CEE economies facing trade-offs between gains in productivity or higher employment levels. Overall, operationalizing developmental pathways in CEE with GDP growth rates seems far from satisfactory and the optimism of short-term catching up with EU15 economies is hardly grounded.

Dependent Underdevelopment?

A second group of authors reach widely different conclusions by focusing on different indicators – namely, that instead of convergence and equalization, post-Socialist restructuring entrenched a combination of old and new disparities between CEE and Western Europe.

József Böröcz thus argues that developmental trajectory of CEE relative to Western Europe and the world economy can be captured in a matrix where the relative contribution of the region to world GDP - and GDP per capita as a share of world mean - constitute two axes for a comparison of dynamic pathways (Böröcz, 2012). In this matrix, Böröcz finds that in spite of a rebound in GDP per capita after the initial contraction of the 1990s (as discussed previously), the weight of CEE economies relative to the world economy has uniformly diminished throughout the restructuring phase.

Figure 1.6. Böröcz' Matrix of Developmental Pathways in CEE



Source: (Böröcz, 2012 p.113)

If anything, the region has thus been unambiguously marginalized according to him: *"The uncomplicated modernizationist expectations that the post-state socialist states would rapidly catch up with the rest of Europe were simply wrong. This, by itself comes hardly as a surprise to global analysts. What is most striking about the post-1989 transformation is the uniformity with which the global economic positions of a vast majority of the region's states collapsed, along basically a single precipitous pattern, followed by a somewhat feeblor rebound. It appears that, ironically, the state socialist period showed much more variation among members of the Soviet bloc than poststate socialism. Whether they are predominantly western Christian, eastern Orthodox, or Muslim, whether their governments pursue policies that are neoliberal embedded neoliberal, or neocorporatist (Bohle and Greskovits 2007), whether they are poorer or richer, small, medium-sized or large, whether they privatized their assets primarily to foreign multinationals or domestic oligarchs, whether their current economy depends on exports of machine products, agricultural goods, or energy and raw materials, each lost global positions, to a significant degree, along both of the dimensions previously surveyed. At best, some could boast only of having regained their already reduced positions of 1990 in GDP per capita terms; others have not succeeded in making even that dubious achievement. Even more striking, none among the 27 postsocialist states surveyed here had*

by 2009 recuperated its already significantly reduced global economic weight of 1989" (Böröcz 2009, p.119).

The contributions of Jacoby et al. typify the insertion of CEE into world markets as an outcome of Western public and private strategies in what they call "backyard management" – resulting in an increase of Western competitiveness at the expense of entrenching structural differences between CEE and Western Europe (Epstein, 2014; Jacoby, 2010; Jacoby & Epstein, 2014). Jacoby and Epstein argue that the insertion of CEE to regional and global markets was shaped *asymmetrically* by EU15 actors: for Western firms, CEE represented an investment opportunity for restructuring their supply chains, while for Western states, CEE economies represented potentially dangerous competitors given their comparative advantage in low wages. The "backyard management" thesis argues that while EU15 public and private interests often clashed regarding the preferred economic mode of integration of CEE – ultimately, they reached uneasy settlements in different issue areas. In all cases however, the newfound position of CEE economies within the European market was decided West of the Rhine. Jacoby identifies three measures as relevant for capturing the changing position of CEE economies in this process: (1) flows of capital, (2) flows of labor and (3) flows of goods and services (Jacoby 2010). In terms of capital flows, CEE is particular in that it does not or only marginally exports capital, while it is among the first targets of foreign investments – a point we have illustrated previously with FDI flows in the case of Poland and Hungary. Jacoby reminds that the share of FDI in GDP was 39% in CEE by 2004 (twice the world average), with particular strongholds such as the financial sector where foreign ownership totaled over 50% compared to the OECD's 20% average. Briefly put, in the field of capital flows, EU15 private interests prevailed, which resulted in a transfer of ownership from CEE to EU15 actors in industrial and banking sectors. In terms of labor flows on the contrary, EU15 states managed to embed legal safeguards that substantially limited the opportunities of CEE workers to migrate: with the exception of Ireland, the UK and Sweden, the remaining 12 EU15 states introduced temporary limitations on CEE mobility. Finally, in terms of trade flows, the early Europe Agreements concluded between the EU and individual CEE states were initially overtly protectionist bilateral treaties: CEE sectors where the region's comparative advantage was blatant such as steel, iron, chemicals and agricultural products – were purely

excluded. However, once CEE productive capacities fell into EU15 hands in the course of privatization, these restrictions were gradually relaxed: as Jacoby argues, this can be explained by the fact that EU15 firms use CEE for assembling and re-exporting industrial goods to EU15 markets. In other words, CEE's export competitiveness is a statistical mirage, which ignores the question of ownership: CEE "exports" are in fact to a large extent EU15 re-exports where the value added contribution of domestic sectors is minimal. As summarized by Epstein (2014), the new position of CEE economies has entrenched pre-existing forms of economic and political inequalities between West- and Central Europe rather than leveling the playing field.

Overall, Böröcz' operationalization of developmental pathways is interesting inasmuch his indicators study actual economic performance and his two relational GDP indicators do paint a different picture than neoclassical models of convergence. However his analysis also suffers from weaknesses: Firstly, he fails to acknowledge that the post-Socialist loss of economic weight in the world economy is not the specificity of a new, colonial form of semi-peripheral integration to world markets. In fact, his data shows a similar downward trajectory for all "core" capitalisms (likely not independently from the concomitant rise of India and China). Second, out of his two indicators, one (GDP per capita) does in fact show CEE's stability (after an initial contraction) instead of downgrading divergence relative to the world economy. Third, he chooses to ditch Poland's clear upgrading trajectory on both his dimensions as a unique outlier case. We argue that as with many analyses rooted in dependency theory, his framework pays insufficient attention to different individual developmental trajectories: the danger with these approaches is that cases that disconfirm the hypothesis of unilateral exploitation in the semi-periphery are simply ignored. The theoretical weaknesses of dependency theory – on which Böröcz' own analysis rests - for explaining different developmental trajectories in post-Socialist CEE are discussed in the following chapter in more detail. On the other hand, "backyard management" is a highly stimulating framework for analyzing the position of CEE in European and global markets and flows, however, we would contend that this operationalization is less attentive to the actual performance of CEE economies than to the institutional foundations of power disparities between EU15 and CEE public and private actors. Put differently, Jacoby et al. mostly examine institutional dimensions of divergence between EU15 and CEE and it is only in the trade

flow dimension where this framework actually examines indicators of CEE *performance*. However, Jacoby et al. raise important points regarding trade flows: firstly, that the value added contribution of domestic sectors are better indicators of developmental upgrading than nominal trade flows. Second, that trade indicators are blind to the question of domestic or foreign ownership, which is highly relevant from a developmental perspective: CEE dependency on EU15 economies is only apparent when it is singled out that industrial productive assets and domestic banking sectors are largely controlled by EU15 firms and banks. This is crucial because EU15 MNCs have the capacity to shape the domestic value added content of their CEE subsidiaries and the distribution of profits internally, within their supply chains. Second, contrary to EU15 countries but also very differently from previous late-industrializers, CEE states are not in control of their financial sectors – whereas public developmental programs in earlier periods crucially relied on the capacity of the state to channel foreign capital to particular sectors.

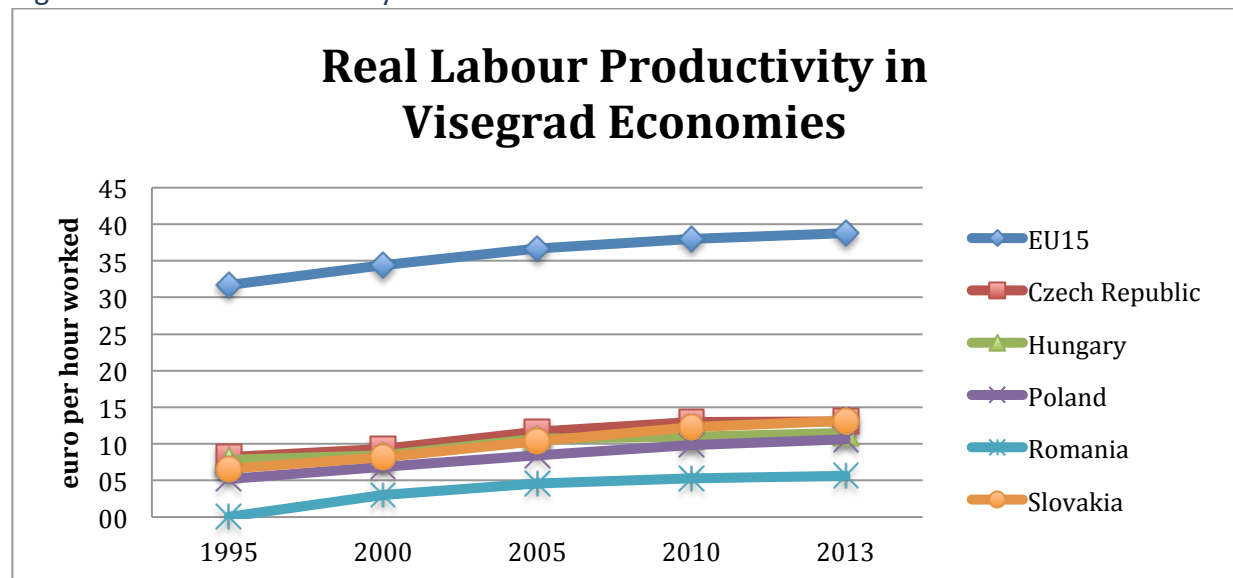
CEE in a Middle Income Trap?

Finally, a third group of authors display a cautiously pessimistic view regarding CEE's capacity to catch up with EU15 and other rich, industrialized economies. We would classify here those authors whose research was influenced by- or responded to- the Varieties of Capitalism (VoC) framework. It is important to note that the "VoC in CEE" scholarship constitutes a broader research agenda within which the Gerschenkronian question of developmental catching up is only one among other themes: these authors seek to capture particular configurations of political and economic institutions in CEE, driven by a taxonomical impetus to classify CEE varieties of capitalisms. The extent to which these institutional configurations enable or prohibit convergence is a (relatively) subsidiary question in this framework. Nonetheless, the "VoC in CEE" framework cannot escape the question of CEE performance in regional and global markets and this group of authors reaches relatively similar conclusions in relation to the catching up potential of CEE economies.

The VoC in CEE agenda is premised on the assumption that particular domestic institutional complementarities create specific comparative advantages that determine

in turn different pathways of transnationalization: consequently, this tradition puts a heavy emphasis on the region's insertion into trade flows in particular. Nolke and Vliegenthart (2009) were among the first to transpose explicitly the VoC framework developed by Hall and Soskice to the CEE region, specifically to the Visegrad countries (Poland, Czech Republic, Slovakia and Hungary). They argue that the combination of a qualified workforce and low wages have specialized these economies in the export of complex, human-capital intensive, semi-standardized industrial goods. Bohle and Greskovits (2012) consider that while the value added content of exports in Visegrad countries reflects an upgrading trend into increasingly complex products, productivity levels continue to set the region apart from Western Europe (2012, p.172). More or less explicitly, Nolke and Vliegenthart as well as Bohle and Greskovits warn of a looming middle-income trap in CEE, which is bound to actually differentiate these economies further from Western types of capitalism rather than produce convergence (Paus, 2012): while the trade integration of CEE (specifically the Visegrad sub-type of countries) through foreign MNCs allows for short-term economic gains (employment, higher wages, increasing value added content of exports), these authors argue that in the long run, these economies don't have endogenous innovation systems, which could (1) sustain long-term productivity growth and (2) create new comparative advantages in capital- and technology-intensive sectors. For these authors, the danger is that the institutional structure of Visegrad economies rely precisely on the outsourcing of technological innovation, which is borrowed through FDI rather than being domestically engineered: Visegrad states have no incentives to finance costly investment programs in human capital, RD and innovation while MNCs equally lack incentives for specializing their CEE plants in production segments that would go substantially beyond the pre-existing comparative advantage of the local workforce in low wages. The VoC in CEE agenda thus points to a superficial short-term convergence between CEE and West European economies, captured by improvements in aggregate indicators such as GDP, GDP per capita or trade balances – which in fact overshadow a structural difference in the institutional foundations of innovation between EU15 and CEE countries. This insight is confirmed by data on productivity differences between Western and Central Europe – where convergence is all but absent.

Figure 1.7. Labor Productivity in CEE and EU15 countries



Source: Eurostat

A note on methods for operationalizing developmental outcomes in CEE

In this section, we sought to stress how dramatically different a picture the extant scholarships paint regarding developmental outcomes and trajectories in CEE economies. As mentioned earlier, the Gerschenkronian question of catching up continues to structure the current debates, however, different methods for operationalizing developmental outcomes or pathways result in very different assessments of developmental performance. In spite of these confusions, we argue that an overview of these literatures nonetheless holds important lessons for proposing an alternative comparative framework of developmental outcomes in CEE.

The first methodological lesson is that distinctions between indicators of economic performance and the institutional independent variables affecting these outcomes should be clarified: Drahokoupil and Myant (2015) argue that an important source of confusion in these debates lies with the fact that two interpretations of developmental divergence/convergence are often used interchangeably: the institutional dimensions of CEE economies, and indicators of these very institutions' economic performance over time: *"(...) The concern with institutional performance, however specified, should be one of the central directions in the CC (comparative capitalism) agenda. The VoC approach*

proposed a typological theory with such a purpose. The debate in the comparative capitalism literature that started with a reflection of the weak points of the VoC approach led CC research away from explaining the economic and other effects of institutions” (Drahokoupil & Myant, 2015).

The second methodological lesson is that many researchers identify a problem with what common aggregates might actually conceal. To put it clearly, the question of domestic versus foreign ownership constitutes a methodological problem for assessing developmental outcomes in CEE: given the striking role of FDI as the primary source of productive investments in CEE economies and the overwhelming share of foreign ownership in strategically important sectors, common aggregates such as GDP per capita or even trade balances represent a statistical mirage. Crucial contributions by Bohle and Greskovits (2012) as well as by Scepanovic (2013) single out precisely that the institutional foundations of technological innovation constitute a fundamental area of divergence between EU15 and CEE economies: this difference might all but escape conventional statistics although it is deeply consequential. Bluntly put, improving trade balances for instance might sustain the illusion of an improving position of CEE economies in transnational markets – but if one fails to acknowledge that CEE exports are overwhelmingly created by EU15 MNCs that own directly domestic productive assets in CEE and capture the lion’s share of profits relative to domestic actors - as mentioned by Jacoby (2010) – these figures might not reveal much in themselves about catching up. Similarly, variations in the value added content of exports are only meaningful if one understands that CEE is highly dependent on technology “borrowed” from MNCs that these national economies do not own and would be hard pressed to replicate (Scepanovic. 2013).

Part 3. An Alternative Comparative Framework

In light of these problems, we argue that an alternative comparative framework of developmental outcomes and performance in CEE would be beneficial. Such a framework should (1) separate dependent variables of performance from the institutional explanations thereof, and (2) recognize that domestic and foreign actors might benefit differently from a given mode of transnationalization within the same

sector. We therefore propose an analytical framework that combines the question of economic upgrading with particular attention to the question of ownership, or more precisely the question of an uneven distribution of benefits between foreign and domestic actors. While methodological nationalism might have a lot of enemies in international political economy in particular, from the perspective of public and private actors in semi-peripheral economies, the only relevant policy question is the extent to which they stand to gain from a particular mode of transnationalization. Therefore, we propose to replace the broader Gerschenkronian research question: *“Is there developmental catching up between CEE and Western Europe?”* - with a more precise formulation: *“Does a particular mode of transnational integration improve the position of a domestic sector in regional and transnational markets? And who does it benefit: MNCs, domestic actors or both?”* Upgrading and the distribution of benefits between domestic and foreign actors thus constitute the two dimensions of our comparative framework of developmental outcomes at the sector level.

Ownership

Stark and Vedres (2006) examined the ownership question in post-Socialist economies in innovative ways. The authors proposed to measure how transnational integration modified linkages between domestic firms and MNCs in CEE. This opened a particularly stimulating agenda as they considered the transnationalization of CEE economies as dynamic relational processes between domestic and foreign actors. Given the particular salience of foreign ownership in the region, post-Socialist CEE economies could thus be viewed as new forms of “mixed” (domestic/foreign) economies³. Stark and Vedres examined different forms of networks between domestic firms and MNCs: this approach implicitly raised the question of distributive problems between domestic and foreign actors. Unfortunately from our perspective, the allocation of resources and the distribution of benefits could only be gauged indirectly in this framework, which focused more on the qualities of *networkedness* than on the underlying distributive problems and backward linkages between foreign and domestic actors.

³ This research agenda was in line with Stark’s previous work on assemblages of public and private property in the aftermath of post-Socialist privatizations.

Figure 1.8. Relative Share of Different Forms of Networks Between Domestic Firms and MNCs in Hungary Between 1987 and 2001

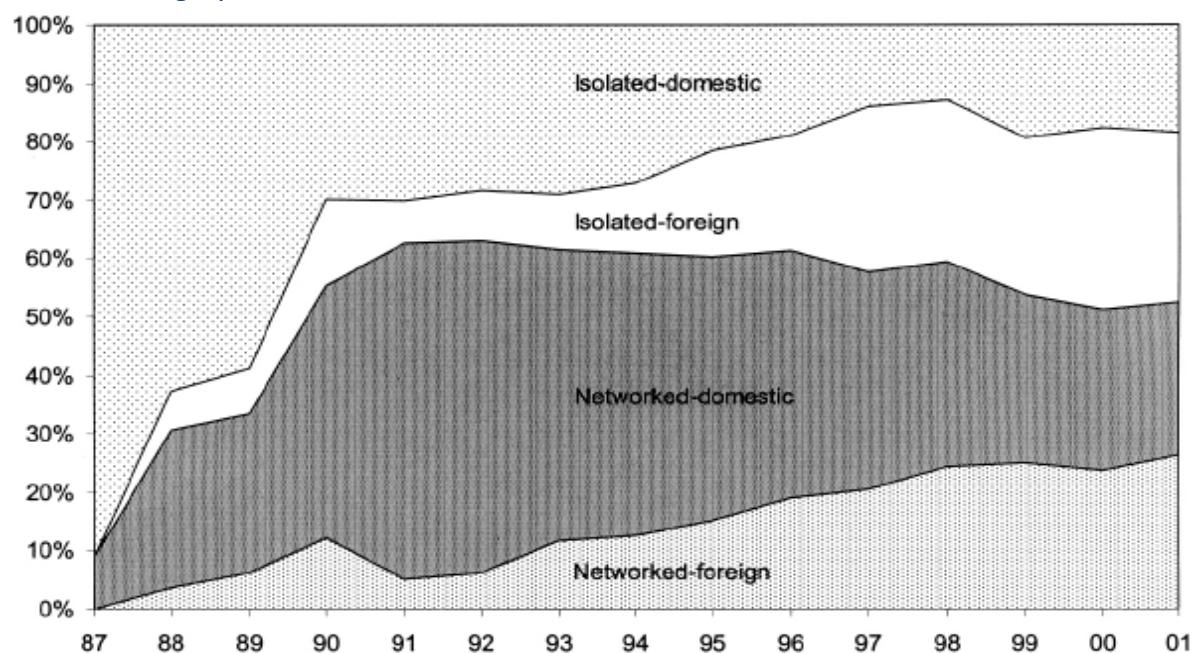


FIG. 1.—Area chart of large firm capitalization: domestic or foreign, isolated or networked

Source: (Stark & Vedres, 2006)

Sector-level performance qualified by ownership

One recent approach by Scepanovic (2013) offers perhaps the most comprehensive attempt at operationalizing developmental performance at the sector level in CEE, while simultaneously exploring the question of distributive problems between foreign and domestic firms through spillovers and backward linkages. Her account of the automotive sector reads as an extreme case where domestic suppliers are virtually entirely marginalized in the new supply chains controlled by MNCs – all the while trade statistics paint a rosy picture of improving trade competitiveness. Scepanovic's meticulous study shows precisely that while conventional indicators of economic performance showcase clear signs of upgrading in CEE automotive production and trade – improvements in volumes and revenues from trade, but even in the value added content of exports - fail to highlight a crucial weakness, namely that automotive supply chains are entirely controlled by foreign MNCs with minimal linkages to domestic actors. For Scepanovic, this raises a problem that goes beyond the question of social exclusion for domestic actors in liberalized sectors: even more important than the marginalization of domestic

firms per se, the problem lies with absent technology transfers between MNCs and CEE economies. Her work reads as a doubly cautionary tale: On the one hand, she highlights the empirical limitations of upgrading strategies where FDI plays both the role of primary financial capital but also – allegedly – substitutes for the need of domestic innovation, investment in human capital, skill formation and RD. While CEE states might have hoped that becoming industrial exporting powerhouses in the new European regional market could be realized without costly public investments and most importantly without domestically engineered technological progress – in fact these economies became entirely dependent on reproducing their unique comparative advantage in low wages, thus falling into the middle income trap hinted at by the students of the VoC scholarship. When the effects of such a weak comparative advantage will fade, these economies risk losing entire industrial sectors overnight – ones they had in fact never owned nor controlled. Second, Scepanovic's work equally reads as a methodological warning for the students of economic upgrading in semi-peripheral late industrializers: her case study shows in rich detail how conventional statistics of economic performance can consistently portray catching up, while simultaneously concealing the structural weakness of a particular mode of transnationalization that relies exclusively on FDI – if the question of ownership is ignored.

Therefore, we would place our own framework in the continuity of Scepanovic's insightful research agenda. Our dual research question of a specific sector's overall economic performance in transnational markets and the distributive problems between foreign and domestic actors mirrors to a large extent Scepanovic's own formulation of her developmental question in CEE: *"(...) the main research question – how foreign investment impacts development – is best understood as being two questions. The first asks about the mechanics of FDI-led development: the ways in which FDI translates into growth and competitiveness, and the structure of alliances and institutions, which support the activities of foreign firms. The second meaning of the question concerns the nature of development taking place under the tutelage of foreign capital – its stability, inclusiveness, distributional consequences, advantages and disadvantages"* (Scepanovic, 2013, p.8).

However, we would also add two important remarks: First, in Scepanovic's case study, the mode of the automotive sector's transnationalization is uniform across different

Visegrad countries. Integration occurs entirely through FDI and the dissolution of pre-existing industrial capacities/firms in the internal supply chains of MNCs. Second, outcomes are equally similar across the region: the entire marginalization of domestic competitors and even suppliers of MNCs – in parallel to improving trade balances. In spite of the glaring importance of automotive sectors for Visegrad economies, we would contend that at a theoretical level, there is no reason for assuming that similar sub-regional CEE varieties of capitalism would uniformly follow the same patterns of transnationalization across countries in a given sector. In industrial sectors with lower technology content in particular, there would be a priori greater scope for variation of transnationalization modes: when accessing technology is cheaper, different options for harnessing it open up for similar countries. Consequently, the distribution of costs and benefits between foreign and domestic actors could likewise follow very different patterns.

Simply put, in proposing a coherent comparative framework that is able to capture and contrast developmental performance in deeply transnationalized semi-peripheral countries, it seems that the best option is to combine the methodological insights gained from two sources: measures of upgrading/downgrading trajectories should be evaluated in light of the distribution of benefits between domestic and foreign actors. Gereffi et al. have consistently analyzed upgrading at the firm level in the framework of Global Value Chains (GVC) theory (Barrientos, Gereffi, & Rossi, 2011; Cattaneo, Gereffi, Miroudot, & Taglioni, 2013; Gereffi, Humphrey, & Sturgeon, 2005; Gereffi & Wyman, 1990): their insights can be mobilized for understanding what are the different scenarios for upgrading from the perspective of domestic firms. This literature identified four routes of possible upgrading: 1.) Process upgrading occurs if within the same production segment the productivity of a firm increases, 2.) Product upgrading occurs if increasingly higher value added products are produced by the firm, 3.) Functional upgrading occurs when firms climb up the value chain and capture a higher value added production segment previously owned by their buyers or suppliers. 4.) Value chain upgrading occurs when the firm is able to diversify into new sectors altogether (Cattaneo et al., 2013). MNCs can affect two types of domestic actors: local suppliers and domestically owned competitors. It is important to distinguish on the one hand whether domestic suppliers of MNCs do increase their productivity or the value added content of

their outputs because of their inclusion in buyer-driven transnational supply chains (Gereffi, 1994). On the other hand it is also important to identify whether the domestic competitors of MNCs are able to increase their productivity, value added contribution and market share or if they are gradually marginalized due to the competitive pressure of MNCs.

Such a framework should be able to identify two trends: (1) Whether upgrading or downgrading occurs within a national sector over time, as measured by aggregate measures on production and export profiles, productivity gains and value added content. This dimension should reflect the overall performance of a domestic sector in transnational markets. (2) By disentangling the “domestic sector” by ownership, what can be examined is whether domestic firms gain or lose in the process relative to MNCs (with a further distinction between suppliers of MNCs and domestically owned competitors to MNCs) – that is, whether MNCs can coexist with domestic rivals or even participate in the upgrading of domestic capacities through horizontal or vertical spillovers - or if foreign capital merely destroys the competitiveness and chances of survival of domestic firms.

If one disentangles the question of a sector’s overall performance in transnational markets from the problem of relative positions of domestic and foreign actors, at the theoretical level, at least four different outcomes can be envisaged:

(1) Improving competitiveness on transnational markets alongside improving competitiveness of domestic firms relative to MNCs. MNC penetration does not threaten the position of domestic firms and producers who control the majority of a domestic market and find stable access to capital and technology that improves their competitive position. One can hypothesize such an outcome in lower technology content sectors where domestic firms are not entirely dependent on MNCs’ proprietary technologies and human capital.

(2) Improving competitiveness on transnational markets accompanied by a marginalization of domestic actors. This is the situation described by Sceanovic in the automobile sector, where both competitors and suppliers of MNCs are entirely

marginalized. This outcome might be correlated with high technology content, which neither domestic firms nor the state are capable or willing to engineer. While the position of a domestic sector might improve on transnational markets, the real beneficiaries are MNCs.

(3) Downgraded competitiveness of the domestic sector but stable position of domestic actors. Domestic firms resist MNC competition on their market, however they don't have the necessary resources (capital and technology) to improve on their competitiveness. As a result, the position of the domestic sector in global markets dwindles.

(4) Downgraded competitiveness of the sector and a marginalization of domestic actors. In this situation, MNCs have no incentives for improving the trade position of a domestic sector: instead, they deplete existing resources. On the other hand, domestic firms are equally incapable to upgrade because they don't have a stable access to capital and technology.

Part 4. Polish and Hungarian developmental divergence in dairy

Manufacturing sectors have provided the bulk of comparative case studies for the students of developmental outcomes in CEE due to their important contributions to GDP and exports in the Visegrad group in particular. A less well-studied sector is agro-food, which might be surprising considering that it is the largest industrial sector in the EU. Moreover, the complex organization of the sector equally lends itself to examining the developmental effects of transnationalization: It is an industrial sector organized around the vertical integration of three separate segments, namely production, processing and retail. FDI targeted the processing and retail segments of the industry early on throughout CEE, while production largely remained in domestic hands –as discussed below, even countries with comparable comparative advantages such as Poland and Hungary have followed very different modes of transnationalization in the processing and retail segments. Given the sensitivity of food security, agriculture and agro-food are among the most regulated sectors both in the EU and globally. However, because of the complex coordination needed between the production, processing and retail segments

pitting domestic and foreign interests against one another, agro-food is also one of the most politically contested economic sectors.

A practical reason for studying specifically the dairy sector in CEE is that it is one of the few case studies that have been explicitly studied from a developmental perspective in the region. The current scholarship on the post-Socialist restructuring of CEE dairy is dominated by a small group of authors around Johan Swinnen since the mid-1990s. Their conclusions mirror to a large extent the optimistic stance regarding an export-oriented developmental model in the broader debate over CEE's catching up capacity. They argue that the effect of FDI on CEE dairy sectors has been largely positive: MNCs brought modern technologies which increased productivity, have implemented modern food standards that increased domestic competitiveness by offering new export markets especially in Western Europe, where EU food standards had previously functioned as non-tariff trade barriers. Furthermore, through their dissemination of formal contractual relations between farmers, processors and retailers, they have contributed to the re-establishment of trust and coordination throughout the supply chain, after the dramatic disorganization that followed in the aftermath of the collapse of Communist centralized hierarchical organization (Dries, Falkowski, Malak-Rawlikowska, & Milczarek-Andrzejewska, 2011; Dries et al., 2009; Dries & Swinnen, 2002, 2005; Dries & Swinnen, 2010; H. Gow et al., 2000; Gow & Swinnen, 1998; H. R. Gow et al., 2000; Johan F.M. Swinnen et al., 2006; J. F. M. Swinnen & Maertens, 2007). Not only did they contribute to the upgrading of their own suppliers through various loan and training programs, but domestic competitors of MNCs also adopted their innovations through learning and emulation.

The present thesis refutes a number of these arguments: notably a biased case-selection whereby most of these conclusions were drawn from the Polish dairy sector's trajectory – a country with relatively low levels of FDI in the sector, which is thus particularly ill-suited for generalizations regarding the inherent upgrading capacity of FDI. By focusing on a comparison between Hungary and Poland's dairy sector, this thesis first aims at redressing this bias by singling out the differentiated developmental impact of MNCs. Most importantly, the present thesis is based on a very different premise in that it seeks to understand why two transition countries with comparable resources and faced with

the same opportunity structure followed different modes of transnationalization leading to vastly different developmental outcomes.

The dairy sector offers an interesting case study in diverging developmental pathways firstly because the structure of supply chains in this sector reflects a complex interaction of domestic and foreign agents. Three segments can be identified in the supply chain: farmers/producers of raw milk, processors (domestic or foreign firms) and retailers (domestic or foreign firms). Global agri-food supply chains have experienced what Reardon et al. termed the “supermarket revolution” in the 1990s, that is the global rise of retailer MNCs both in the Global North and South: agri-food sectors have become buyer-driven supply chains where the oligopsonies of a few regional or global retailer chains have been able to influence both prices and the top to bottom diffusion of regulatory standards down the supply chain to processors and producers (T. Reardon, Timmer, & Minten, 2012). While the concentration of the retail segment in the hands of MNCs in agri-food chains is a global phenomenon, important variations subsist in the market share and competitiveness of domestic and foreign firms in the processing and production segments.

Poland and Hungary entered post-Socialist restructuring faced with similar problems: Productivity levels were substantially lower than in Western Europe, the genetic stock of existing cow herds was poor, resulting in low milk yields and low quality. Neither public nor private actors were prepared for the implementation of complex food standard regulations such as HACCP and ISO 9000, that functioned as non-tariff trade barriers on Western European markets. Domestic producers and processing firms required new sources of capital and access to technology for realizing the necessary investments for remaining on the market. In parallel, domestic markets were gradually liberalized in both countries and better capitalized MNCs, specialized in higher value added products represented a new form of competition both on domestic and on export markets – all the while traditional Socialist export markets coordinated under COMECON collapsed.

In Poland and Hungary, FDI has targeted both the retail and the processing segments of the dairy supply chain differently: In Hungary the state actively fostered FDI as early as the first wave of privatizations in 1992-93. The concentration of the four biggest operators in retail amounted respectively to 59% in Hungary and 21% in Poland by 2003 (Lukácsik et al., 2009). By the end of the decade, Hungarian dairy was extraordinarily concentrated in the hands of MNCS: foreign supermarket chains controlled 82% of the retail market and the share of foreign participation in dairy processing rose from 59% in 1997 to 87% by 2000 (Vőneki & Mándi-Nagy, 2014). By contrast, Polish dairy processors continue to control close to 80% of the domestic market as opposed to MNCs (Szajner & Vőneki, 2014b). Both Poland and Hungary experienced a dual trend: on the one hand a steady decline in the number of farms, especially among smallholders who proved incapable to implement new food standards. This social cost was compensated for by an increase in productivity and rising revenues from exports. Productivity measured in milk yields increased faster in Hungary, notably due to the concentration of producers in larger farms endowed with more capital: it increased by 35% between 2000 and 2010 and only 19% in Poland (Szajner & Vőneki, 2014b).

This differentiation doesn't only boil down to the difference in market size: one can observe a steady upgrading of higher value added product types in Poland (butter, cheese, curd), while on the contrary Hungary increasingly specialized in lower value-added market segments (concentrating on raw milk and powders). Hungary began to import higher value-added products while specializing in the production and export of the lowest value-added dairy products (fresh milk and powder). Even more surprisingly, by the turn of the millennium, Hungary began to experience a trade deficit not only in high- but also in low value-added dairy goods such as fresh milk. The exact opposite trend played out in Poland where not only did the sector achieve a positive trade balance but where the most dynamically growing product types were precisely concentrated in higher value-added good such as cheese and curd.

Poland and Hungary thus followed two different routes to the transnationalization of their dairy sectors with equally diverging developmental consequences on domestic actors: Hungary integrated the dairy sector to transnational markets almost exclusively

through MNCs. The consequence was a gradual collapse of competitiveness and a downgrading of production and exports into lower value-added products. MNCs firmly controlled both the retail and processing segments while domestic competitors in the processing segments virtually disappeared by the end of the 1990s⁴. In Poland by contrast, FDI never threatened the market share of domestic processing firms. The Polish sector specialized into increasingly complex products with higher value added. The 2004 EU accession marks a key critical juncture after which Poland's dairy exports soared. Conversely, the period following EU accession marked for Hungary the beginning of a trade deficit in dairy products, the rise of imports in higher value added products such as cheese (imported not only from EU15 countries but also from Poland) and a specialization into the most primitive products such as fresh milk and powder.

⁴ This trend has reverted over the last decade, an interesting evolution that is examined in the third chapter.

Chapter 2

We have proposed a framework for contrasting developmental outcomes and trajectories in the previous chapter, which answered to an empirical puzzle, namely diverging performance and different distribution of benefits between MNCs and domestic actors at the sector level in two semi-peripheral transition economies confronted with the same challenges. The present chapter offers a theoretical basis for identifying independent variables that could account for this divergence. We examine competing arguments in the literatures on developmental potentials in transnational markets and argue that neither the over-determination of dependency theory, nor the agency of external actors can fully account for the empirical divergence in modes of transnationalization and developmental outcomes displayed in Polish and Hungarian dairy. Therefore we present an alternative hypothesis, namely that variation in the capacities and organization of domestic public and private actors as well as their linkages are better suited to explaining these contrasted developmental pathways. The fact that domestic actors steered transnationalization differently in these two countries has important theoretical and policy implications: it would point at an understudied scope for domestic developmental agency even in “dependent market economies” such as Visegrad economies, in sectors such as dairy - where lower technology requirements than in automotive or electronic sectors resulted in a substantial scope for variation in developmental trajectories. In a first section, we clarify the role of capital and technology as the basic assets needed for spurring competitive upgrading in developing economies. In a second section, we examine why theories of transnationalization rooted in the dependent underdevelopment framework are unable to explain diverging developmental outcomes between similar semi-peripheral economies. In a third part, we examine the role of transnational private and public actors as potential developmental engines with a capacity to distribute financial and technological assets necessary for upgrading domestic sectors such as dairy. In a fourth part, we define the dimensions of public policy, which determined *how* diverging developmental pathways resulted in an “autonomist” developmental model in Poland and an “integrationist” model in Hungary. Finally, we mobilize the insights of Evans to show how variation in

the capacities and organization of state and non-state actors, as well as their type of linkages might explain *why* the two countries followed diverging pathways.

Part 1. Resources for Development: Capital as financial and technological assets

A number of hypotheses have been proposed for explaining economic development or the lack thereof: at a most basic level, differences in wealth and competitiveness are rooted in different stocks of capital. Building on the work of Douglas North (North & Thomas, 1973), it is common to distinguish between physical and human capital: the former encompasses financial and non-financial economic assets necessary for production, and the latter represents accumulated knowledge and the transmission thereof (education, skill formation). The combination of a given stock of physical and human capital determines the total factor productivity (TFP) of an economy (Baier, Dwyer, & Tamura, 2006): logically, the more important the available stock, the higher is TFP. The developmental upgrading of dairy sectors in Poland and Hungary would thus have required financial capital and technology/human capital at the onset of the transition process, similarly to any other industrial sector. Low productivity, obsolete machinery and technologies that characterized these sectors necessitated costly investments in dairy production and processing. However, it should be also clear that more capital- or more labor- intensive activities require different combinations of economic and human capital, in other words financial assets and technology. A difference in agri-food sectors such as dairy -compared with the automotive industry for instance, as examined by Scapanovic (2013) – lies with a lower level of technology requirements: technology is embedded in machinery that can be purchased, whereas in capital-intensive high-tech sectors such as automobiles, the sector-specific technology is a form of knowledge and human capital that is proprietary to firms, essentially MNCs, that control the market. By contrast, in sectors such as dairy, access to financial capital not only solves the need for investments necessary for upgrading but it also guarantees access to technologies, which can be expected to raise productivity, and allow for the production of higher value added goods. Financial capital cannot substitute perfectly for human capital, knowledge and technologies: methods of management, inter-firm relations such as the vertical coordination of the supply chain between producers and processors cannot be bought entirely. Yet the substitution of financial capital for human

capital is easier than in sectors where technology transfers are legally constrained by intellectual property rights regulations. Concretely from the point of dairy producers and processors in Poland and Hungary, this means that their upgrading hinged primarily on finding access to financial assets: knowledge and technology could be bought for the larger part at least.

However, deriving developmental outcomes from variation in stocks of TFP is largely tautological: rich countries are assumed richer because they have more-, and better factors of production. Semi-peripheral and transition economies such as CEE suffer from a higher scarcity of both physical and human capital compared with Core capitalist economies, which explains why they are relatively less productive, less competitive and poorer. What is missing is a theory of developmental change over time. As pointed out by Acemoglu et al., the real question is what explains differences in TFP across time and societies, or in our case, what explains increasingly better or worse developmental outcomes between two semi-peripheral economies over time (D. Acemoglu, Gallego, & Robinson, 2014; Daron Acemoglu & Robinson, 2012). And here the apparent academic consensus is shattered: some expect transnational market integration to downgrade the competitiveness in semi-peripheries such as CEE, others think on the contrary that external private and public actors can remedy the relative shortage of capital and increase competitiveness, while a third camp argues that domestic variables are better suited for explaining diverging developmental pathways. In other words, the extant literatures on transnationalization have fundamentally different expectations as to how the integration of a capital-scarce, poorly competitive domestic sector into transnational markets would change opportunities for accessing economic and human capital necessary for upgrading.

Part 2. Underdevelopment in the semi-periphery: The limitations of Dependency Theory

Dependency Theory's appeal for understanding development in the CEE region

The argument of structural underdevelopment in transnational markets is tied to the literature on dependency. This view can be traced back to a Marxist interpretation of the

international division of labor (IDL) (Lenin, 1963), later complemented with Emmanuel's unequal exchange theory (Emmanuel, 1969), which built itself on Raul Prebisch's work, who had identified an uneven distribution of profits in international trade between exporters of manufactured goods in "Core" economies and exporters of raw materials in the "periphery" (Birkan, 2015). The work of André Gunder Frank (1966) and Immanuel Wallerstein (1974) further cemented the scholarship of what came to be known as dependency theory. In this view, economic exchanges are assumed structurally unequal and serve to assert hierarchical relations of exploitation. However, dependency theory goes further in refuting a tenet of classical Marxism, namely that capitalism would be capable of producing economic development at all. Dependency theory in its orthodox variant argues on the contrary that instead of compensating for a domestic shortage in capital, technology and knowledge which developing economies could use to their advantage, transnational markets in fact fix a stable position of exploitation between the Core and "the Rest" in the IDL. For André Gunder Frank (1966), only temporary isolation from the "Core" did historically allow for a relatively egalitarian distribution of wealth increase in developing countries. Stronger ties to leading capitalist economies on the contrary produced an economic geography of hierarchical dependence between Western metropolises, their satellite metropolises in the South and finally the underdeveloped agricultural hinterlands thereof. The argument is not only that transnational integration is developmentally detrimental to poorer economies, but that developmental gains from transnationalization in the Core and developmental costs in the periphery and semi-periphery are part of the same process: it is the forced underdevelopment of the Rest, which ensures the extraction of rents from unequal exchange by Core economies.

The later formulations of dependency theory relax the hypothesis of absolute developmental stasis in the IDL but argue that individual "deviations" of successful catching-up constitute a minority of outliers, which don't refute the fundamentally negative developmental effect of transnational integration for poorer economies. Arrighi et al. argue that those - Amsden in particular - who see a rise of developing nations in the late 20th century confuse economic development with industrialization (Arrighi, Silver, & Brewer, 2003). They argue that when observing the evolution of differences in wealth between peripheral, semi-peripheral and core economies throughout the 20th century,

the developmental gap remains stable notwithstanding a “real” convergence limited to the degree of industrialization (between industrializing semi-peripheries and a de-industrializing Core). In Prebisch’s and Emmanuel’s footsteps, they believe that the developmental gap between the Core and “the Rest” follows cycles where core economies dispose of a surplus of accumulated economic and human capital, which enables them to invest periodically in new comparative advantages when the semi-periphery begins to threaten their competitiveness. Catching-up is elusive because gains in productivity and competitiveness rely on the diffusion of knowledge and technologies from the core to “the Rest”, while the rate of profit of such innovations declines in time and in space: by the time peripheral and semi-peripheral economies can adopt these innovations, all their competitors equally dispose of them. Emerging economies thus always face competitive pressures unknown to innovators and early adopters in the capitalist Core that had enjoyed monopoly rents from these innovations in the timeframe when most of their competitors hadn’t had access to similar knowledge and technology. Eventually, when the rate of profit of innovations becomes marginal for core economies by virtue of their diffusion in the developing world, the Core disposes of an accumulated surplus, which can be invested in engineering new comparative advantages and buffer the adaptation costs to a new innovation cycle. Far from a peculiar tropism, Arrighi’s argument is at the heart of most approaches rooted in the World-System Analysis developed by Wallerstein, where inequalities between economies are perceived as cyclically reproduced.

The hypotheses of the dependency framework inform to various degrees a wide range of contemporary work on development in CEE: we mentioned in the first chapter that Böröcz (2012), Jacoby (2010), Epstein (2014), Drahokoupil and Myant (2015) share a number of underlying hypotheses regarding the rent-extracting efforts on the part of EU15 economies in relation to CEE: namely that CEE was integrated into supply chains controlled by EU15 MNCs, to the extent that these MNCs could exploit comparative advantages in CEE to increase their own competitiveness – with a distribution of profits clearly tilting in favor of MNCs.

Limitations of Dependency Theory for explaining sector-level developmental divergence

In our empirical case, the dependency framework might offer an explanation to the downward trajectory experienced by the Hungarian dairy sector: the argument that deeper transnationalization, higher FDI- and MNC penetration actually force semi-peripheral economies to specialize in low value added (VA) production segments could be a guiding hypothesis behind the faltering competitiveness of the Hungarian case, where MNCs acquired an overwhelming majority in the processing and retail sectors in the 1990s. Symmetrically, however, dependency is unable to explain how the Polish dairy sector could increase its competitiveness over the same period. If public and private actors strategies located in the “Core” determined entirely the developmental pathways of semi-peripheral economies, it would be difficult to understand why MNCs would have tolerated a Polish dairy sector largely owned by domestic actors to become one of the biggest dairy exporters in the world – all the while they actively downgraded the Hungarian sector’s competitiveness. Dependency theory thus offers no explanation to the divergence in developmental outcomes between the two countries: to the extent that the developmentally negative effect of transnationalization is supposedly constant, since it is determined by the interests of MNCs located in the Core to maintain higher productivity than their suppliers and competitors in the semi-periphery, dependency theory is unable to explain empirical developmental trajectories that show developmental divergence between countries located in the same region of the global economic geography structuring the IDL. Therefore, we examine in the following two competing arguments, which propose on the contrary hypotheses for the possibility of developmental upgrading through transnationalization.

Part 3. Securing Capital and Technology in Open Markets

Upgrading through MNCs

Contrary to the dependency argument, a large literature argues that it is precisely through transnational market integration that poorer economies stand a chance for moving upwards in the IDL as transnational actors might compensate for the structural lack of domestic resources, which hinders developmental upgrading.

Amsden's work integrated the question of ownership to the developmental question of access to capital: she argued that foreign capital could indeed help peripheral economies bypass the technology frontier and move into higher VA sectors (industrial goods) (Amsden, 2001, p.52) . In her view, foreign non-financial capital embeds technical-scientific innovation and know-how, consequently, buying-, borrowing- (or stealing) foreign capital substitutes foreign capital – that is, more productive innovation - for the lack of endogenous innovation in developing economies. In other words, acquiring foreign capital bypasses the need for late-industrializers to engineer innovation systems from scratch (at least in the initial phase of technology adoption). Amsden contrasts two distinct modes of foreign capital appropriation: the autonomist strategy of post-War South-East Asian countries where domestic firms could buy foreign technology and the integrationist developmental pathway, where foreign capital came hand in hand with direct foreign ownership of domestic firms and productive assets (factories, production plants etc.). In light of the Visegrad countries' performance in the automotive sector, Scepanovic (2013) proposed to amend Amsden's framework by adding the category of "hyper-integrationism" for describing a mode of transnationalization where domestic firms are largely marginalized by MNCs, both as competitors and as suppliers, and where they do not benefit from any technological spillovers. Scepanovic thus argues that in high technology-content sectors, technology transfers are an empirically unsubstantiated myth. By contrast, Amsden's more optimistic stance is better suited to sectors such as dairy, where domestic firms can actually acquire technology embedded in machinery: in other words, an integrationist mode of transnationalization is likelier to manifest in a sector such as dairy, than Scepanovic's hyper-integrationism because technology transfer is not limited by proprietary technologies.

Yet, the question is what theoretical ground is there to expect MNCs as providers of foreign capital and owners of domestic assets to play an upgrading developmental role in receiving economies: how can they compensate for a lack of financial and human capital among domestic firms? The potential upgrading role of MNCs on a receiving economy is threefold: (1) The decision for MNCs to invest abroad entails important transaction costs, it is therefore argued that MNCs only ever invest if they have firm-specific assets that domestic companies don't dispose of (Dunning, 1979). In other

words, MNCs are (in theory) by definition more competitive than their domestic counterparts: the capital and technology they bring into a host economy is assumed to be more productive than domestic factors of production. The question is whether the host economy (domestic firms) can benefit from financial assets and more productive technologies used by MNCs. In light of the vast literature on the topic, the venues of such diffusion can be broadly clustered into three channels of transmission: (1) direct linkages between MNCs and domestic firms, (2) indirect linkages and (3) positive externalities derived from the presence of MNCs.

Direct Linkages

Direct transmission mechanisms between MNCs and domestic firms entail a wide spectrum of inter-firm and inter-sector processes. Vertical spillovers occur between foreign and domestic firms integrated in a single supply chain of buyers and suppliers. Horizontal spillovers cover inter-firm relations between MNCs and domestic firms, which operate in distinct supply chains at similar stages of the production chain (e.g. MNCs and their domestic competitors or MNCs and domestic firms in different sectors, linked through inter-sector outputs) (Lenaerts & Merledeve, 2011). Vertical spillovers have only been studied extensively since the 1990s although the extant scholarship finds more empirical evidence for them than for horizontal spillovers (Javorcik, 2004). In vertical spillovers, it is argued that the more productive capital and proprietary technology of MNCs can have an upgrading effect on domestic suppliers and buyers of MNC outputs. The mechanisms hypothesized behind this trickle down effect are diverse: (1) In relation to their domestic suppliers, MNCs might opt to upgrade them directly by providing them with capital (preferential loans typically) when domestic outputs don't conform to product- and process- standards required by MNCs (Moran, 2001). (2) Increased competition is an alternative route: Instead of direct financial transfers, MNCs might simply use stringent product and process standards in their procurement contracts to increase competition among domestic firms that seek to integrate their supply chains. It is argued that this would incentivize domestic firms to find alternative routes for productivity gains or make new investments (when they actually have access to financial capital) that they wouldn't have otherwise undertaken (De Mello & Luiz, 1997; Wang & Blomström, 1992). (3) The demonstration effect of managerial or

marketing techniques used by the MNC upstream might convince domestic suppliers to adopt these innovations in order to realize productivity gains (Wang & Blomström, 1992).

Indirect Linkages

Indirect linkages correspond to horizontal spillovers, when MNCs and domestic firms are not directly integrated in the same supply chain. They might be competitors or trading partners but located in different industries, purchasing intermediary goods from one another. The mechanisms behind such spillovers are notably (1) competition and (2) the demonstration effect (just as in vertical spillovers). Since MNCs are assumed to be more competitive than domestic firms, their arrival increases competitive pressure on domestic firms that have new incentives for realizing productivity gains (in the same way that domestic MNC suppliers might compete between themselves) (Aitken & Harrison, 1999; Kokko, 1996). The demonstration effect (or emulation) presupposes that domestic firms copy technological or managerial innovations used by MNCs and thus drive their own competitiveness upward. Another form of indirect linkage for spillovers can be the movement of skilled workforce from MNCs to domestic firms, whereby investments in domestic human capital realized by MNC are eventually “shared” with domestic firms when former MNC employees join domestic firms (Fosfuri & Ronde, 2001; Haacker, 1999).

Positive externalities

MNCs can also have indirect positive externalities on receiving economies: since the decision of MNCs to invest abroad is assumed to be based on firm-specific assets domestic firms don’t dispose of, MNCs are likelier to specialize in more capital-intensive activities and/or be more productive than the bulk of domestic firms. Higher productivity in MNCs is expected to translate into higher wages for the workforce than in domestically owned firms. Higher wages could in turn augment demand and thus spur

investments in a virtuous upgrading cycle⁵. A second type of indirect positive externality is the possibility of a shift in the receiving economy's export profile due to MNCs' pioneering role in paving the way for export markets that domestic firms hadn't previously exploited: competition on the domestic market or the demonstration effect of MNCs export strategies could thus incentivize domestic firms to specialize in new export markets (Greenaway, Sousa, & Wakelin, 2001).

Before turning to the relevance of this literature in highlighting the empirical puzzle of the present thesis, it should be noted that although a particularly large body of work on the upgrading potential of MNCs in emerging economies has indeed highlighted a number of theoretically grounded venues for the transmission of capital and technology from the core to the periphery through FDI and MNCs, the empirical tests remain – somewhat surprisingly – largely inconclusive: Blomström (1999) and Görg (2003) have proposed extensive reviews of the extant literature on evidence for spillovers in empirical case studies and find that no general positive relationship between FDI and domestic upgrading seems to exist. Instead, contradictory empirical evidence opened up new research agendas integrating new independent variables for explaining spillovers or the lack thereof, most notably a receiving economy's *absorptive capacity*, which is particularly relevant for our argument as discussed in the following section on domestic institutional pre-requisites for developmental upgrading.

The literature on the upgrading role of FDI and MNCs in the periphery and semi-periphery offers one potential explanation to the divergence in developmental outcomes observed at the sector level in Polish and Hungarian dairy. First, contrary to the developmental stasis or downgrading assumed by the dependency scholarship, it argues that transnational integration can on the contrary spur upgrading and an upward movement in the IDL. Second, this would imply in particular that the developmental upgrading observed in the Polish case reflects some form of technology- and capital transfer from MNCs to domestic firms and suppliers. As a matter of fact, the relationship

⁵ Amsden also elaborated briefly on this form of positive externality (upgrade through higher wages) but it has to be mentioned that at the theoretical level, it isn't very solid: the share of MNCs in domestic employment would have to be overwhelming, while an increase in purchasing power is likelier to raise imports especially in higher value-added goods. At the empirical level, there is some evidence for higher wages paid by MNCs than domestic firms, but not of an entire shift in consumption patterns resulting from it (Head, 1998; Lipsey & Sjöholm, 2001).

between FDI and the competitiveness of Polish dairy has received a focused attention over the past decade and a distinct literature argues precisely that foreign capital played the key role in upgrading domestic capacities.

Upgrading through FDI in the context of Polish and Hungarian Dairy

Dries, Germenji, Noev and Swinnen (2009) studied the upgrading effect of FDI on CEE dairy sector competitiveness: they defined different dependent variables whereupon the effect of MNCs can be observed, such as herd size, competitiveness, (measured as productivity in milk yields and food safety standard adoption), as well as the stability of inter-firm coordination through the use of private contractual relations between MNC buyers (either in the milk processing segment or by retail chains) and domestic suppliers (either farmers or domestic processing firms). Although they didn't use regression models because of the scattered nature of data, they relied on descriptive statistics, qualitative interviews and process tracing. They argued that a positive relation seemed to exist throughout the CEE region between FDI (MNC presence) and upgrading in all the abovementioned dimensions. These authors have jointly and independently produced further evidence for this thesis: Dries and Swinnen (2004) studied vertical integration in the Polish sector under FDI and argued that after an initial breakdown of buyer-supplier relations previously organized by State Ministries under Socialism, MNCs offered an alternative in the form of private contracts, which helped restructure the market as a stable mechanism for vertical integration and coordination in the supply chain. This confirmed a previous study by Gow and Swinnen (2000) where they had similarly noted a stabilization of vertical coordination through private contracts between MNCs and domestic firms in CEE. Furthermore, they found in the same paper that MNCs usually offered direct access to financial capital to their domestic suppliers in CEE: typically, MNCs would guarantee collaterals when suppliers applied for loans from commercial or development banks. It is argued that those domestic producers, which took part in this form of private assistance, saw their revenues increase (MNCs worked indirectly as providers or rather guarantors of access to capital for realizing investments which increased their productivity) (Dries & Swinnen, 2004; Dries & Swinnen, 2010).

Another venue of capital and technology transmission from MNCs to domestic firms and producers was the use of stringent food safety standards integrated into the

procurement contracts: Dries, Germenji, Noev and Swinnen (2009) argue that MNCs played a pioneering role in the diffusion of more stringent food safety standards than the ones in place before their arrival. This is important because standards act as non-trade barriers to trade: therefore, the adoption of stringent standards allows for foreign export market penetration, which would be otherwise impossible. They argued that domestic competitors of MNCs soon emulated these practices: Polish processing firms began to implement the same kind of standards that MNCs required from their suppliers and gradually learned from the pioneering role of MNCs in finding new export markets (particularly exports to the EU). Finally, Dries, Germenji Noev and Swinnen (2006) equally studied the effects of FDI on CEE dairy sectors in the retail segment through the arrival of MNCs supermarket chains. They recognize a negative effect on the survival rate of domestic producers throughout the 1990s, when farmers unable to comply with the procurement contract clauses (most notably food safety standard compliance) of MNC retail chains were forced out of the market: in Poland, Hungary, the Czech Republic, Slovakia and Estonia, more than 50% of the registered workforce left the market in the wake of post-Communist transition in agri-food sectors. However, the authors suggest that in spite of this social cost, even this process resulted in positive developmental outcomes such as an increase in the average farm size and increased concentration upstream in the production segment. Furthermore, they argued that MNC retail chains played an equally important role in the enforcement of food safety standards, just as their colleagues in the processing segment, and thus contributed to a substantial increase in competitiveness (Johan F.M. Swinnen et al., 2006).

Overall, it would seem that this particular literature on FDI and upgrading in CEE dairy sectors offers a convincing explanation for the possibility of movement between developmental positions as defined in the framework of the first chapter. What is more, it finds empirical evidence for the transition mechanisms of capital and technology highlighted in the broader literature on FDI, MNCs and upgrading. Indeed, the phenomena described by these authors confirm many of the abovementioned hypotheses: the existence of vertical spillovers and backward linkages between MNC processors/retailers and domestic producers/suppliers (through direct financial assistance, capital provision, standard diffusion) as well as horizontal spillovers exemplified by the demonstration effect that domestic competitors would have

benefitted from (learning by emulation) and an increased climate of competition, which would have improved domestic productivity.

In light of such an overwhelming evidence to the positive correlation between FDI, MNCs and developmental upgrading, it could seem surprising that the present thesis questions many of these findings: We argue that in the absence of convincingly falsifiable quantitative data based on a lack of available resources, the evidence for such a positive correlation is at the very least questionable in light of Poland's relatively lesser level of inward FDI in the dairy sector compared with other CEE countries such as Hungary for instance: while Hungary had enjoyed earlier and substantially higher FDI in the dairy sector, it underwent a gradual collapse in competitiveness throughout the 1990s, especially accelerating after EU accession when the trade balance became negative even in lower value-added dairy products (while imports of higher value-added goods have symmetrically risen). The Swinnen, Dries et al. literature – mirroring the hypotheses of the broader literature on the upgrading role of FDI and MNCs – would expect precisely the opposite trend in Poland and Hungary's developmental pathway, if indeed, developmental upgrading was, as argued in these literatures, primarily determined by the trickle-down effect in financial and human capital from MNCs to domestic firms. In light of these, it would seem on the contrary that the hypotheses of the broader and sector-specific literatures on FDI as the primary source of upgrading in peripheral and semi-peripheral economies don't reflect the empirical cases studied in this thesis: as such, their hypotheses don't offer convincing explanations for such a divergence in developmental trajectories between Poland and Hungary.

Upgrading through transnational public actors and integration regimes (TIRs)

A different literature studies another form of exogenous upgrading, namely the developmental role of Transnational Integration Regimes (TIRs) as coined by Bruszt and McDermott (2014). The TIR literature extends a concern for developmental outcomes to a vast array of pre-existing scholarship on transnational market-, regulatory- and regional- integration, where distributive outcomes from the perspective of receiving developing- or transition economies are often overlooked (Bartley, 2007; Büthe & Mattli, 2011; Burkard Eberlein & Grande, 2005). In parallel to the scholarship on the upgrading

role of FDI and MNCs, the TIR literature argues that transnational public actors such as the EU Commission (in the particular context of European regional integration) might upgrade domestic public and private capacities in transition economies, with the result of increased competitiveness. A prime case study for examining this hypothesis is precisely the experience of CEE countries, where domestic institutional change was conditioned and steered by a decade-long regulatory harmonization process (EU *acquis* adoption). The TIR literature notably uses the evidence uncovered by the Europeanization research agenda, which had focused on the effects of regulatory harmonization on domestic institutions (F. Schimmelfennig, 2005; F. Schimmelfennig & Scholtz, 2010; Frank Schimmelfennig & Sedelmeier, 2005; F. Schimmelfennig & Trauner, 2009), but rather than staying within the parameters of formalistic legal transposition-, compliance- or infringement with EU regulations, it also studies the effects that this form of externally-steered institutional change had on the competitiveness of national economies in CEE (as well as other similar semi-peripheral regions such as Mexico in NAFTA).

Bruszt and Vukov (2014) provide a rationale as to why Core economies might have used the EU Commission's agency in order to improve competitiveness in CEE: they argue that the historical experience of German reunification proved decisive in showing the tremendous social and economic costs entailed by a complete economic collapse such as the one endured by the former GDR (Bruszt & Vukov, 2014, p.16). They argue that the Copenhagen criteria for EU accession adopted in 1993 formulated a key criterion, namely "the capacity to withstand competitive pressure", in reference to the negative experience of German reunification: as a consequence, EU15 countries would have had a rational stake in guaranteeing that CEE economies be competitive enough by the time of EU accession so as to avoid a rapid meltdown in the Common Market. Another motive on the side of the Commission was the fear that, firms from the CEE countries will have low capacity to comply with the EU market rules and large-scale non-compliance on the side of CEE firms might undermine the integrity of the common market. The question however, is the extent to which this motive would have translated into a "positive" or a "negative" developmental agenda.

The TIR literature identifies mechanisms through which a transnational public actor such as the EU could have a positive developmental upgrading effect on CEE economies. It is argued on the one hand that the EU disposed of positive instruments for capacity building: (1) institution-building (such as the establishment of national regulatory authorities or the necessity for candidate states to re-learn sector-level planning through national development plans, strategies and frameworks), (2) the provision of financial capital channeled to specific domestic target groups or policy areas in the form of pre-accession funds and post-accession structural funds and (3) the selective empowerment of domestic advocacy coalitions (most notably NGOs invested in the adoption of more stringent EU standards in the fields of human rights or environmental regulation). On the other hand, the conditionality method, which systematically pointed out and sanctioned areas of non-compliance with EU regulation (and thus raised the credible threat of delayed or blocked accession) in yearly-compiled progress reports – constituted the “negative” developmental arm of the EU’s “sticks and carrots” strategy vis a vis CEE.

Overall, the TIR framework argues that the combination of negative and positive instruments ensured – in theory – the capacity for the Commission to affect both the external “supply” and the domestic “demand” for institutional change (compliance with the EU *acquis*). Furthermore, this literature argues that besides *policy instruments*, the EU’s management of CEE accession also made use of *innovative governance mechanisms*, which it calls a non-hierarchical “multiplex problem-solving ability”, in line with a number of researchers, who had emphasized the EU’s capacity for adapting governance methods to the problems uncovered during the pre-accession phase (B. Eberlein & Radaelli, 2010; Grabbe, 2006; Lavenex, Lehmkuhl, & Wichmann, 2009; Sabel & Zeitlin, 2010; Zeitlin, 2011).

Thus, the TIR framework argues that transnational public actors such as the EU disposed of policy instruments that could – a priori – strengthen domestic competitiveness through at least three channels: (1) in relation to domestic firms, targeted programs of capital provision mirror to a certain extent the upgrading role of MNCs in providing easier access to productive (financial) capital, (2) What Bruszt-McDermott and the anterior Europeanization literature call the conditionality method is

functionally a system of disciplinary regulatory implementation, which encompasses a wide array of technical product and process standards that were written into the accession chapters. In that sense, the EU's capacity to enforce and implement technical standards can be likened to the role that MNCs played in the diffusion of such standards through their inclusion into procurement contracts with domestic producers and firms. Assuming that the adoption of MNC or EU technical norms entails positive developmental outcomes (increased competitiveness for domestic actors)⁶, there is a theoretical similarity between the role of MNCs and the EU as developmental agents through regulatory diffusion. (3) Most importantly, the TIR literature argues that the EU had an upgrading role on domestic public institutions. This is a major difference with the literature on MNCs and FDI as the prime drivers of developmental upgrading: the underlying hypothesis is that domestic public institutions matter for developmental outcomes, a question often ignored by the former scholarship, with tremendous consequences as pointed out in the subsequent parts.

Upgrading CEE dairy sectors in TIRs

Besides providing a general theoretical framework for considering the EU (and similar public transnational organizations) as a potential upgrading agent, the TIR literature equally conducted empirical case studies for verifying these hypotheses. Most relevant from the perspective of the present thesis is a study by Bruszt and Langbein (2014) on the EU's role in the evolution of Polish and Romanian competitiveness in the dairy sector. The paper identifies a similar puzzle to our research agenda: an upward trajectory in Polish competitiveness and a downward trajectory in the case of Romania. However, it seeks to uncover specifically the role that the EU accession process played on these trends. The authors propose contrasted findings: (1) They argue that the EU's intervention in the dairy sector mirrored its "sticks and carrots" approach to CEE accession: the EU's pre-accession funds represented a (relatively) cheap access to capital for domestic firms but the EU also imposed regulatory compliance with technical standards, which increased the risk of market exclusion for under-capitalized small

⁶ A hypothesis which is naturally highly contentious empirically, since the costs associated with rule compliance have clear exclusionary effects on domestic firms unable to secure the capital necessary for investments that could guarantee compliance (Lee, Gereffi, & Beauvais, 2010).

producers and firms, (2) Bruszt and Langbein recognize that a substantial difference in developmental outcomes resulting from EU accession in the dairy sector can be found in pre-existing institutional differences between the two countries, both in terms of domestic actors' capacity to organize effectively (strong coordination and organization in Poland, atomized actors in Romania) and in the two states' public administrative capacities (competent in Poland, inefficient and corrupt in Romania).

Ultimately, Bruszt and Langbein show that at the theoretical level, a transnational public actor such as the EU disposed of resources that were vital for the competitive upgrading of CEE dairies (financial capital and technological modernization – notably through food safety standard adoption). The EU Commission guaranteed a potential access to these resources, however it left CEE states free to distribute these among domestic non-state actors as they saw fit. Consequently, while the Polish state efficiently used these resources for an inclusionary upgrading investment program, in the Romanian context however, the state allocated these resources to a few large (often foreign owned) dairy firms. Different interest coalitions and differences in the two states' administrative capacity to implement public policies resulted in widely different developmental outcomes. Thus, Bruszt and Langbein's case study showed that while transnational public actors such as the EU can provide capital and technology - ultimately accessing and distributing these resources varies with the organization of domestic state and non-state actors in CEE. Overall, Bruszt and Langbein concede that the EU is an engine of development only a minima in CEE, where its developmental effects are largely mediated by domestic variables.

A note on theories of exogenous developmental upgrading (FDI and TIRs)

The dependency argument, which assumes a stasis or downgrading for semi-peripheral economies over the course of transnationalization, proves unable to shed light on our empirical puzzle on two accounts: Polish dairy's upward developmental trajectory over the course of market liberalization and EU accession most fundamentally contradicts the over-determination of the dependent underdevelopment argument. Second, this literature offers no convincing explanation to increasing *divergence* in developmental trajectories between similar countries. Building on these insufficiencies, we have

examined two competing hypotheses, that provide on the contrary a theoretical basis for (positive-, upward-) dynamic change between developmental positions over time: the first hypothesis argues that increasing transnationalization in the form of FDI and the arrival of MNCs can compensate for the domestic shortage of financial capital and technology. However, this literature would expect diametrically opposing outcomes to the empirical trajectories of Poland and Hungary if there was a stable correlation between FDI levels and increasing inclusionary competitiveness. Thirdly, we examined the hypothesis put forward by the TIR literature, which argues that transnational public actors and integration regimes such as the EU might play a similar role to MNCs in facilitating access to capital and diffusing stringent technical standards in semi-peripheral economies. However, the very case study of developmental divergence in CEE dairy sectors put forward in the TIR framework draws attention to a third factor explaining developmental success or failures: domestic institutions.

Upon closer scrutiny, it seems that these two literatures, which study the developmental role of transnational private and public actors converge on a crucial insight, namely that variation in domestic factors is probably more important for explaining developmental outcomes than transnational public or private agency. In fact, the vast literature on the relation between FDI, MNCs and developmental upgrading underwent an important evolution where domestic variables have been re-evaluated: Blomström (1999) recognizes that domestic public policies are crucial for explaining spillovers between MNCs and domestic firms. In fact, an important subfield of research on FDI is concerned today with the identification of what they call a receiving economy's *domestic absorptive capacity*: empirical evidence shows that the economic-, social- and technological upgrading effect of FDI is strongest in economies that already possess a reliable infrastructure, an efficient state, investments in human capital etc. (Nguyen, Duysters, Patterson, & Sander, 2009).

In parallel to the FDI literature, Bruszt and Langbein (2014) also point to domestic institutions as key variables for explaining developmental upgrade in Poland and stasis or downgrade in Romania. We argue that the theoretical consequences derived from these observations are notable: The fact that domestic actors and institutions filter transnational processes and agency seems intuitive and banal... However, if it can

empirically demonstrated that variations in domestic variables can explain diverging developmental trajectories even in deeply transnationalized regions such as CEE, typically used as prime examples of dependency, it would mean that contrary to many extant underlying hypotheses about the developmental consequences of transnationalization, which argue that the developmental trajectories of small, open developing economies are over-determined by exogenous factors, there remains in fact a crucially important (however reduced) scope for different strategies of transnationalization even in highly transnationalized semi-peripheral or transition economies... at very least, in less technology-intensive sectors.

Part 4. Domestic Developmental Public Policies

The more orthodox tendencies of dependency theory's appetite for explaining underdevelopment don't help understanding dynamic developmental pathways: especially not when semi-peripheral countries might empirically display an upgrading trajectory both in relation to a sector's competitiveness but also to the degree of inclusiveness afforded to domestic actors – which corresponds to the case of the Polish dairy sector. On the other hand, while the developmental role of transnational private and public actors has spurred a vast scholarship on processes by which these actors might compensate for a domestic lack of capital and technology (financial and human capital), the evidence remains inconclusive: the literature on MNCs' upgrading role stresses the receiving economy's pre-existing *absorptive capacity*, while the TIR literature identifies transnational public actors such as the EU as having a minimalistic, negatively-defined developmental agenda vis a vis CEE. Empirically, the Hungarian dairy sector's performance seems to run fundamentally counter the argument of successful upgrading through FDI. Therefore, while transnational actors certainly played a key role in influencing the course of post-Socialist restructuring at the level of the dairy sector in Poland and Hungary, the question remains: Why did the two countries exploit a similar opportunity structure differently, resulting in so different outcomes? In the following sections, we will first clarify *how* domestic policies differed between Poland and Hungary, that is, what were the dimensions in which domestic developmental agency could diverge between the two countries. In the last section, we will provide a

theoretically grounded argument as to why the two pathways followed different routes leading to differentiated developmental outcomes.

Developmental Public Policies in autonomist and integrationist models

In attempting to find theoretical justifications to the developmental effects of public policies, it seems relevant to yet again refer to Amsden's work: Amsden was one of the most vocal critics of an over-determination towards developmental stasis or downgrade inherent to the dependency scholarship, whether in its traditional "orthodox" form or in its later "ASB" formulation. In her view, public developmental policies played the crucial role in the catching-up of late-industrializers (Amsden, 2001).

Amsden (2001) argues that historically, developmentally successful emerging economies never followed a "low-road industrialization" strategy: the successes of late 19th-early 20th century rising champions of industrializations such as Germany or the U.S.A. never based their catching up with Britain on low wages and low skills. Neither did post-War Japan nor South Korea. In fact an important critical scholarship demonstrated that successful economic development always hinged on protectionist policies rather than the myth of free trade, be it in pre-industrial Britain (Chang, 2008), or post-War Japan (Johnson, 1989) and South Korea (Amsden, 1989).

Amsden draws a distinction between two types of developmental successes: Western first industrializers that increased their competitiveness through radical innovation during the Industrial Revolution (eg. Germany or the U.S.A.), and "late industrializers" in the 20th century, which managed to catch up with the former even in the absence of endogenous technological innovation. These two processes had different pre-requisites: institutional histories in the *longue durée* in the Western case (the emergence of a bourgeoisie, or of scientific rationality) were boosted by investments in human capital resulting in feedback loops between science and industry, which spurred innovations that increased gains in productivity (e.g. Fordism). In the South-East Asian case of late-industrializers, moving beyond a comparative advantage in low-skill and low-wage sectors was possible to the extent that the state proved capable of putting in place an incentive structure based on export subsidies conditional on the performance of the

private sector. The metrics of performance could be multifaceted: be they targets for an increase in output, productivity gains or compliance with technical standards, what mattered was the capacity of the state to monitor, reward compliers (extending subsidies) and sanction non-compliers (withdrawing subsidies). What is remarkable in Amsden's concept of successful late-industrialization is that to her, the lengthy Western process of endogenous innovation resulting in productivity gains could be artificially engineered by a disciplinarian conditionality method, a role, which fell on the state in post-War Asia: this system of rewards and punishments guiding and shaping the private sector towards increasingly complex technology played the same role in Asia as the lengthy trials and errors of spontaneous attempts by innovators and entrepreneurs in the West⁷.

What distinguishes autonomist and integrationist developmental strategies in Amsden's framework is most fundamentally the ownership of firms (in other terms, FDI) that acquire and transpose more productive knowledge and innovation into a developing economy. Autonomists rely on domestic firms and use the instrument of conditional export subsidies, that is the state's disciplinarian conditionality mechanism for rewarding efficient learning as described above, while integrationists rely entirely on MNCs for skill formation and RD. In other words, learning is an outsourced process in the integrationist model and an endogenous process in the autonomist one. Policies are also salient for integrationist strategies as for autonomists: for the former however, public policies are not meant at nurturing the learning capacity of domestically owned firms but rather at incentivizing FDI by MNCs in order for domestic firms to integrate these foreign-owned supply chains and benefit from MNC-supplied technology and innovation without actually owning them: *"Moreover, even the success of the 'integrationist' approach depends strongly on the level of local capabilities; the weaker the capabilities, the fewer the 'spillovers' from foreign firms. Nevertheless, the independent model emphasizes 'getting the institutions 'right' ' and building skills, while the integrationist model emphasizes 'getting the prices 'right' ' and buying skills. From the viewpoint of knowledge-based assets, the two approaches are very distinct and, as suggested in previous chapters, not necessarily of equal promise"* (Amsden & Chu, 2003, p.293).

⁷ Briefly put, this is what Amsden calls „learning“ in late-industrialization.

Briefly put: public agency can play a fundamental role in shaping the mode of a sector's transnationalization leading to differentiated developmental outcomes for the sector in general and for domestic actors in particular. (1) First, the state can mobilize foreign capital and channel it to particular domestic target groups that it seeks to upgrade. (2) Second, it can shape property rights institutions, which guarantee a broader or more restricted access to resources for domestic actors. (3) Thirdly, it can use public regulation for managing the competition between MNCs and domestic actors. We argue that the Polish and Hungarian states differed substantially in *how* they used all three instruments.

The role of the State in harnessing foreign capital

Albert O. Hirschman famously said that *"Development depends not so much on finding optimal combinations for given resources and factors of production as on calling forth and listing for development purposes resources and abilities that are hidden, scattered or badly utilized"* (Hirschman, 1958, p.5). For Hirschman the problem of underdevelopment is thus not a lack of resources (capital) per se, but is instead rooted in the inefficient utilization of existing capacities. For him, development is an organizational problem - and therefore an institutional problem. The broader institutional determinants of developmental upgrading are discussed in the subsequent section, however Hirschman's insight is first relevant to us because it highlights a dimension where the state can play a fundamental role: if development hinges less on available stocks of capital than it is the outcome of different methods for coordinating whatever available resources, "listed for development purposes" - the state is an ideal candidate for pooling, organizing and coordinating capital transfers in less competitive sectors. When domestic capital is scarce, the state can harness foreign capital in different forms and channel it to domestic sectors where it is lacking.

As pointed out previously, the competitive upgrading of Polish and Hungarian dairy sectors depended to an important degree on accessing financial capital. As the two subsequent empirical chapters discuss in detail, the starting position in Poland and in

Hungary was similar: domestic producers and farmers had an urgent need for productive investments in order to improve their competitiveness. However, in both countries, financial capital was dramatically scarce: On the one hand, state budgets experienced worsening current account deficits aggravated by punitive levels of foreign debt accumulated under state Socialism. On the other hand, the emerging domestic financial markets were severely undercapitalized and fragile, a fact further aggravated by incompetent public regulatory choices: Stark and Bruszt showed for instance how reforming the Hungarian law on accounting in 1991 actually created private debt for domestic companies by classifying assets as liabilities (Stark & Bruszt, 1998, p.150). Neither the state nor a nascent commercial banking sector could provide the capital necessary for saving domestic dairy producers and processors from bankruptcy, even less to satisfy their needs for productive investments. However, the domestic shortage of financial capital has been a staple of all late-industrializers: in this situation, the state can play an alternative role by harnessing foreign capital and channeling it to strategic domestic sectors and target groups. Yet, contrary to late-industrializers in the Global South in previous eras, the sources of foreign capital were substantially reduced for Poland and Hungary: unlike South East Asian economies, they couldn't count on foreign creditors to continue financing their budgets as they had already been entangled in a debt crisis by the early 1990s. In this situation, the available sources of foreign capital would take on different shapes: IFIs and the EU's financial transfers were initially the only sources on which the state could count. Surprisingly, Poland utilized a structural adjustment loan from the World Bank called ASAL for saving domestic dairy cooperatives from bankruptcy. Later, the Polish state built a complex institutional framework for pooling domestic and foreign capital, and channeling it specifically for the investment needs of domestic agri-food firms (among which dairy): newly created public organizations such as the Agricultural Modernization Agency (ARMA) and the Foundation of Assistance Programmes for Agriculture (FAPA) were tasked with coordinating foreign capital accessed from the World Bank, bilateral aid from Western European governments, and the EU's early assistance programs. In a stark contrast, the Hungarian state satisfied the financial appetite for capital investments by privatizing domestic dairy processing firms and transferring them in bulk to MNCs. In other words, by selecting different methods for solving the undercapitalization problem of domestic dairy sectors, Poland and Hungary selected widely different modes of

transnationalization for their sectors. The Polish strategy - although relying on aid and structural adjustment loans instead of public foreign debt - in many ways mirrors the “traditional”, autonomist developmental strategy of 20th century late industrializers. On the contrary, the Hungarian strategy closely followed Amsden’s “integrationist” model - relying on MNCs for accessing financial capital and technology, in the hope that through horizontal and vertical spillovers, they would upgrade the sector’s overall competitiveness and domestic capacities. In light of their respective economic performance, clearly, the Polish model fared substantially better both in upgrading the competitiveness of the domestic dairy sector on transnational markets and in securing the position of domestic dairy cooperatives. The last section of this chapter further details why these two states might have opted for radically different strategies. For the time being, what is important is that differences in how the state solves the problem of access to (foreign) capital are likely to lead to different modes of transnationalization: in an autonomist model, the state can be expected to use its own institutions to channel foreign capital from any available source to the domestic sector it seeks to upgrade. In an integrationist model, the state on the contrary solves the capitalization problem of domestic firms by integrating them to the supply chains of MNCs - in laymen terms by selling them. As a matter of fact, the Polish state chose the first option, while Hungary opted for the second: by providing different policy answers to the problem of undercapitalization, Poland and Hungary also selected different modes of transnationalization - which fared very differently from a developmental perspective.

The Role of the State in shaping property right institutions

While earlier research on economic take off and development had focused on the role of factors of production such as financial stocks and technology, there reigns today a consensus on the primordial role of domestic institutions - particularly property rights institutions - as even more fundamental determinants of economic development. This constitutes an area where domestic public agency can crucially affect developmental outcomes is the capacity of the state to shape property rights institutions. In that regard too, the Polish and Hungarian state opted for widely different strategies in reshaping property rights during the early 1990s.

The institutional dimension of development was not a discovery *ex nihilo*: modernization theory had since Marx and Durkheim posited the necessity for peripheral countries to replicate the Western experience of institutional change while later contributions debated the possibility for late-industrializers to leapfrog some of the institutional pre-requisites that had been necessary for the consolidation of competitive economies in the capitalist Core (Gerschenkron, 1962). In light of our puzzle, a first relevant question is which domestic institutions can affect developmental outcomes, the second is whether the Polish and Hungarian states managed these “developmentally relevant” institutions differently.

Douglass North defined institutions as the “*humanly-devised constraints that shape human interaction (which) structure incentives in exchange, whether political, social or economic*” (North 1992, p.5). While neo-classical economics had assumed that exchanges realized Pareto-optimal equilibria under pure and perfect market conditions, North argued that in the presence of information asymmetry and important transaction costs, institutions function as solutions to reducing the uncertainty inherent to both. Institutions form the framework for the organization of polity and economic exchange, however path dependency occurs since “*the organizations (which) owe their existence to the institutional matrix, they will be an ongoing interest group to assure the perpetuation of that institutional structure*” (North 1993, p.6) . In other words, institutions determine the context within which political and economic actors operate, and their rules fix a particular opportunity structure, which sanctions alternative rationalities, while “insiders” (i.e. political and economic elites) have a structural interest in perpetuating the very rules, which favor the concentration of political and economic power in their hands. However, institutions are not created equal from a developmental perspective: some favor economic growth while others impede it.

By the turn of the century, Peter Evans (2004) considered the “institutional turn” as complete in the field of development studies when he quoted Hoff and Stiglitz (2001) saying “*[d]evelopment is no longer seen primarily as a process of capital accumulation but rather as a process of organizational change.*” “*Capital fundamentalism,*” with its focus on increasing the capital stock, has been supplanted, first by “*technology,*” then by the role of ideas more generally, and finally by “*institutions*”. The notion that institutions are the

primary independent variables for explaining different developmental trajectories is also captured by Dani Rodrik's famous argument that "*institutional quality trumps everything else*"⁸ (Rodrik, Subramanian, & Trebbi, 2004). However, which institutions matter for development remains a contentious question.

The neoliberal agenda offers a minimalist approach to the linkage between institutions and developmental outcomes. In hindsight it is perhaps not surprising that the Bretton Woods donor organizations such as the World Bank and IMF were early adopters of the institutionalist paradigm: variation in domestic institutions served as a convenient scapegoat for explaining away the failure of generic export-oriented developmental strategies to spur growth in the periphery for two decades (H. J. Chang, 2007). Neoliberal developmentalism borrowed from New Institutional Economics (NIE) the hypothesis that economic exchanges are perturbed by transaction costs and information asymmetry, consequently developmentally "good" institutions are those that reduce transaction costs: from that perspective, public infrastructure (transportation and telecommunication) is a first key to economic development (Cattaneo et al., 2013)⁹. The second type is a plethora of governance-related indicators of "good governance" and "institutional quality" that reduce transaction costs¹⁰: donor organizations devised "global standards institutions" akin to decontextualized Platonic ideals¹¹ and sought to transplant them in highly diverse pre-existing domestic institutional contexts in what Evans called "institutional monocropping" (Evans, 2004). Third come property rights

⁸ It should be noted that Rodrik was arguing primarily against Jeffrey Sachs and Jared Diamond for whom geography and climate played a more fundamental role in explaining developmental pathways.

⁹ Although even the role of infrastructure proved contentious: World Bank economists Bernard Hoekman and Ben Shepherd (2013) argued that projects targeting infrastructure upgrading (such as the ones widely financed by the World Bank) reduce transaction costs for all firms (Hoekman & Shepherd, 2013), while Mayer and Milberg (2013) argued on the contrary that infrastructure upgrading largely profits MNCs while smaller domestic firms and communities are unlikely to benefit from such gains unless they are exceptionnally well organized.

¹⁰ Such as: "*political democracy; an independent judiciary; a professional bureaucracy, ideally with open and flexible recruitments; a small public-enterprise sector, supervised by a politically independent regulator; a developed stock market with rules that facilitate hostile M&A (mergers and acquisitions); a regime of financial regulation that encourages prudence and stability, through things like the politically-independent central bank and the BIS (Bank for International Settlements) capital adequacy ratio; a shareholder-oriented corporate governance system; labour market institutions that guarantee flexibility*" (Chang, 2007, p.19).

¹¹ Such as the „efficient protection of property rights“, „accountability“, „transparency“, „human rights“ etc. All of which became „governance-related conditionalities“ attached to loans. See notably Kapur and Webb (2000) in Evans (2004).

institutions: while the former two are rather contentious, there is a wide consensus on the role of property rights institutions as stepping- or stumbling blocks.

Property rights institutions are important in two dimensions: First, they represent rules for the distribution of wealth among diverse domestic groups. Second, the stable guarantee of private property rights is necessary for the profit motive and thus for the accumulation and productive investment of capital necessary to spur growth. Thus property rights institutions vary in two dimensions from less to more egalitarian systems of wealth distribution, and from less to more stable systems of private property protection. Acemoglu, Johnson and Robinson have offered extensive work on the developmental impacts of variation in these two dimensions (D. Acemoglu et al., 2014; D. Acemoglu, Johnson, & Robinson, 2001): they argue that *“good economic institutions are those that provide security of property rights and relatively equal access to economic resources to a broad cross-section of society”* (D. Acemoglu, Johnson, & Robinson, 2005, p.395). The underlying hypothesis is that property rights institutions, which guarantee access to capital and technology to a “broad cross-section” of domestic actors create incentives for the state to cooperate with empowered private actors. Alongside Acemoglu et al., Peter Evans argues that these developmental coalitions between state and non-state actors are vital for pooling and distributing whatever available resources: By contrast, exclusionary property right regimes are likely to pit the interests of a minority against the needs of a national sector: productive investments necessary for upgrading domestic competitiveness will be resisted if the protected minority of big owners considers these as jeopardizing their profits (Evans, 2007).

Similarly, unstable property rights, that is legal systems, which don't define private property clearly and don't offer credible guarantees to the protection thereof, are likelier to discourage capital accumulation and productive investment. What is more original is that Acemoglu et al. are fully aware of the political-economic struggles sustaining different types of property rights institutions. They argue that: *“Economic institutions encouraging economic growth emerge when political institutions allocate power to groups with interests in broad-based property rights enforcement”* (D. Acemoglu et al., 2005, p.387). In other words, and contrary to Marx, they hypothesize the precedence of political institutions over economic ones: developmentally positive

(relatively egalitarian) economic institutions only emerge if the interests of political elites correspond to the interests of a “broad cross-section of society”. Acemoglu et al. offer numerous historical examples to sustain this claim, most notably under colonial conditions: in colonies where Europeans settled en masse, they established democratic institutions, economic institutions were also more egalitarian, which in turn spurred growth and economic development (and conversely)¹². Mahoney reached similar conclusions by studying the developmental pathways of four Central American coffee exporting economies (Guatemala, El Salvador, Colombia and Costa Rica): he identified two institutional models, one where agricultural land remained exclusively in the hands of a small elite cultivating *latifundia* (in Guatemala and El Salvador) and a model where the plots of smallholder farmers were tolerated (Colombia, Costa Rica) (Mahoney, 2001) The latter model spurred higher investments in human capital by the state and produced an inclusive type of growth, while the former maximized oligopolistic rents but maintained the relatively low VA comparative advantage of these economies¹³.

In the regional context of CEE, the state had a key role in shaping property rights institutions: post-Socialist restructuring entailed precisely a new allocation of resources from primarily state-owned forms of ownership to private property. Privatization strategies determined new property rights institutions, and the extant literatures on different privatization schemes across states and sectors suggests that the resulting property rights institutions showed considerable variation in both the legal stability of ownership and the inclusiveness criteria singled out by Acemoglu et al. Just as in relation to the problem of access to capital, Poland and Hungary also diverged in how they reformed property rights institutions: In Poland, the state stopped short of

¹² Acemoglu et al. consider that local population density and the availability of natural resources explain in turn the establishment of more or less egalitarian political and economic institutions in a paradoxical way: where population density was higher, colonizers were likelier to establish extractive institutions exploiting the local workforce. Where resources were scarcer and population density lower, they had incentives to establish more democratic political institutions that favored a more egalitarian distribution of wealth.

¹³ There might be reasons to criticize this type of research: for instance Chang (2007) argues that in light of the vast literature produced in this framework, the very definition of property rights institutions still remains elusive. They notably single out that institutional *forms* and institutional *functions* are systematically confused: the more or less egalitarian distribution of wealth is an institutional function, which can be satisfied by a variety of formal and informal institutional forms. However, we contend that the general argument remains valid even if better definitions are necessary.

eliminating dairy cooperatives inherited from state Socialism. The major benefit is that these represent inclusive property right institutions, where farmers-producers also own processing plants. On the other hand, Hungary's privatization agenda virtually eliminated producer cooperatives, while it chose to sell processing plants to MNCs – therefore instituting an exclusionary property right regime in the dairy sector (from the perspective of domestic actors), where farmers' access to productive assets was undermined – while domestic actors lost the ownership of processing plants as well.

The role of the State in regulating MNC-domestic firm relations

The two preceding dimensions of public developmental agency – (1) harnessing foreign capital “*to be listed for development purposes*” and (2) devising more or less inclusionary property rights institutions command vast scholarships. However, there is also a third arena where the state can shape developmental outcomes, namely re-regulating relations between MNCs and domestic firms. This last dimension has received less attention: the developmental effects of public regulation are usually analyzed in the context of protectionist economies where tariffs shield off competition and public subsidies nurture infant industries. What is seldom examined is the capacity of developing states to re-regulate linkages between MNCs and domestic firms even *after* liberalizing a domestic sector.

While MNCs might –theoretically– provide domestic actors with financial capital and technology, they also pose tangible threats to domestic firms, whether their own suppliers or domestically owned competitors. In relation to domestic suppliers, MNCs can choose to shift the costs of adaptation to technical standards entirely on domestic SMEs and producers. Similarly, MNCs, to the extent that they dispose of more productive capital and technology than domestic competitors, pose an obvious competitive threat to the latter both on the domestic and on export markets. The marginalization of less competitive domestic suppliers or direct competitors is sometimes treated as a developmentally positive effect in the literature on FDI and upgrading as described above, however, this argument ignores the tremendous social and economic costs resulting from wide-scale economic marginalization. In the previous chapter, we have

defined developmental outcomes explicitly encompassing the rate of survival of domestic suppliers and competitors.

Some authors have previously proposed a classification of policies regulating MNC-domestic firms linkages, such as David Greenaway (1992), whose typology of “Trade Related Investment Measures” or TRIMS was simplified by Görg (2003) as in table 2.1.

Table 2.1. David Greenaway’s typology of Trade Related Investment Measures

Instrument	Intended effect
<i>Input TRIMs</i>	
Local content requirements	Specify that some proportion of value added or intermediate inputs is locally sourced.
Local equity participation	Specifies that some proportion of the equity must be held locally.
Local hiring targets	Ensure specified employment targets are hit.
Expatriate quotas	Specify a maximum number of expatriate staff.
National participation in management	Specifies that certain staff must be nationals or sets a schedule for the 'indigenisation' of the management.
R&D requirements	Commit multinationals to investment in research and development.
Technology transfer	Commits multinationals to local use of specified foreign technology.
<i>Output TRIMs</i>	
Export controls	Specify that certain products may not be exported.
Licensing requirements	Oblige the investor to license production of output in the host country.
Technology transfer	Commits multinationals to a specified embodied technology.

Source: Görg, 2003, p.34

The state can play a developmental role by regulating MNC-domestic firms relations through different instruments: (1) A first venue is for the state to strengthen the competitiveness of domestic suppliers and competitors relative to MNCs. (2) A second alternative is to incentivize spillovers between MNCs and domestic firms, (3) Finally, a third alternative is to punish or use the threat of public regulation in order to prevent MNCs from acquiring unfair rents in relation to domestic firms.

Support domestic firms: level the playing field between MNCs and domestic firms

The use of national preference clauses in public procurement laws are a common feature of thinly veiled protectionism even in smaller emerging economies (OECD, 2013). Another method, particularly common in the retail sector, is to increase administrative costs on bigger (MNC) stores in a bid to protect smaller (domestic) shops: legislating opening hours and store size is widespread in transition (e.g. Hungary) and Core economies as well (e.g. France, UK) (Haskel & Sadun, 2009). The state can also use branding and public certification schemes to increase the competitiveness of domestic products: the rise of private standards often constitutes an overwhelming challenge to domestic suppliers in developing countries who often lack the necessary capital to invest in modernization and thus integrate the supply chains of TNCs (Berdegue, Balsevich, Flores, & Reardon, 2005; Fabrizio Cafaggi, 2011). “Branding from below” entails the creation of certification schemes that can either brand regional/geographic/national products or market the sustainability and fair distribution of wealth created in the production chain (fair-trade) (Humphrey & Memedovic, 2006). An important constraint on the state’s ability to level the playing field between MNCs and domestic firms in open markets is that subsidies and state aid are often explicitly banned in WTO regulations, bi- and multilateral trade agreements or in regional integration projects and free trade areas such as the EU. However, there remain sectors both at the global and regional levels where subsidies remain in place: agriculture is a key example (the EU’s Common Agricultural Policy still represented 40% of total EU expenditure in 2013 down from 70% in 1980)¹⁵. Price-, quality- and export subsidization has been at the core of the EU’s agricultural support policy: however, there is ample evidence that MNCs benefit rather more from CAP and EU structural funds than smaller domestic firms and producers (Medve Bálint, 2014). Alternatively, public regulation can also enhance the sector-level organizational capacity of domestic actors: specifically in agro-food sectors, a global problem rooted in the imbalance between highly concentrated segments of the supply chain in higher value added activities

¹⁵Source: http://ec.europa.eu/agriculture/cap-post-2013/graphs/graph1_en.pdf accessed 01/02/2014

(processing and retail), typically controlled by MNCs, while domestic actors concentrated in production remain atomized (Thomas Reardon, Barrett, Berdegue, & Swinnen, 2009). In such instances, the creation and subsidization of collective ownership-, coordination- and mobilization institutions (typically cooperatives and sector level unions) aims at increasing the bargaining power of domestic actors.

Overall, there seems to be solid theoretical and empirical evidence to suggest that public policy support (whether in the form of capital transfers, investments in skills, RD or regulatory tools) destined to enhance the capacities of domestic suppliers and competitors to MNCs are doubly beneficial: On the one hand, they lessen the chances of a negative competitive shock, which would out-crowd domestic firms due to high differences in productivity. Just as importantly, enhanced competitiveness actually increases the possibilities for spillovers between MNCs and domestic firms: Glass and Saggi (1998) suggest that higher levels of technological capacity increase potential spillovers from MNCs. Ari Kokko (1994) found that backward linkages increased when levels of productivity between MNCs and domestic suppliers were lower, while Moran et al. considered that: *“the level of technological and managerial capabilities among local businesses determines whether they are likely to qualify as suppliers to foreign investors or to respond positively to the productivity shock created by the foreign presence”* (Moran, Graham, & Blomström, 2005, p.393).

Foster spillovers

Mandatory national content requirements or tying MNC investment to joint-ventures with domestic firms have been widespread strategies in China’s developmental strategy (OECD, 2013). Both instruments seek to propel vertical spillovers and backward linkages for domestic firms to benefit from MNC technologies and know-how. A limitation of these instruments lies with the size of the domestic market: aside from BRICS and similar big emerging economies, smaller countries pursuing an integrationist strategy usually don’t have sufficient leverage over MNCs to impose such rules.

Constrain MNCs

Besides the threat of MNCs outcompeting domestic competitors, a related concern lies with their treatment of domestic suppliers: limited labor rights, constrained wages of locally employed workforce but also financial concerns such as payment delays to suppliers (an important concern in agro-food sectors where goods are rapidly perishable) are potential areas where MNCs' asymmetric buying power on domestic firms might encourage them to extract unfair rents from domestic firms and producers (Gereffi & Christian, 2009). Domestic public regulation might preempt this through two channels: (1) The public regulation of private contract law: In this case, public authorities have oversight over the contractual clauses between MNCs and domestic firms. Ironically, in order to safeguard the interests of domestic firms, competition law can be a useful instrument for defining illegal practices (F. Cafaggi, 2011; Scott, Cafaggi, & Senden, 2011). The public legislator can either fix compulsory minimum standards in these contracts or define a set of unfair contractual clauses and unfair business practices, which can be punished by a national regulatory agency. The alternative is that public authorities don't regulate MNC-domestic firms relations directly but use the threat of hierarchy to force the adoption of self-regulatory standards.

As the next chapters will show, Poland and Hungary followed equally different paths in the use of regulatory instruments meant at shielding off domestic actors from MNCs: the Hungarian state has become highly proactive in that regard, while in Poland these instruments are not considered necessary.

Part 5. Explaining Developmental Divergence at the Sector Level in Poland and Hungary

In light of the dominant theories on economic development, we identified financial capital and technology (or human capital) as the two fundamental resources necessary for upgrading. We examined whether the role of external public and private actors such as the EU and MNCs in compensating for a lack of domestic stocks of capital could explain developmental divergence between Poland and Hungary. We have concluded

that neither the role of transnational public nor private actors can explain alone why the two cases followed dramatically different pathways. The argument of dependent underdevelopment would expect the sort of developmental downgrading observed in Hungary, but it is unable to explain Poland's upward trajectory. Conversely, the literature on upgrading through FDI would expect stronger competitiveness in Hungary than in Poland in light of deeper foreign capital penetration: yet the empirical situation is the exact opposite. In light of these, we identified three arenas in which domestic public agency could affect developmental pathways: We argued that public developmental agency can play a crucial role in selecting a particular mode of transnationalization and can affect developmental outcomes in three ways: (1) States can choose different options for providing the financial and human capital necessary for economic development. They can take on themselves the task of harnessing foreign capital from various sources and coordinating investment programs necessary for the sector's competitive upgrading, or they can solve the capital requirement problem by transferring domestic firms to richly capitalized MNCs., (2) States have the ability to change property right institutions in a more or less inclusive manner, thus strengthening or weakening domestic private actors and (3) States dispose of a series of hard- and soft law instruments for regulating relations between MNCs and domestic suppliers as well as competitors thereof.

Poland and Hungary did in fact diverge in all these policy areas as the next chapters will show in more detail. In Poland, the state played a key role in pooling financial capital, while the Hungarian state counted on MNCs to "solve" capitalization. In Poland, the state opted for a more inclusionary property right regime in the dairy sector by keeping Socialist producer cooperatives in place, while in Hungary the state enforced an exclusionary property right regime by dismantling cooperatives. In Hungary, the state eventually began using regulatory tools for redressing the marginalization of domestic actors vis a vis MNCs, while in Poland such instruments were seldom used after EU accession once domestic dairy cooperatives were upgraded to a level where they could survive on open markets.

The fact that these two countries chose so different policy options might be surprising because the scope for public developmental agency in CEE is often assumed marginal. Given the structural specificities of post-Socialist transition in the 1990s as opposed to previous developmental trajectories in the Global South, CEE is often singled out as a textbook example of economic dependency given the role played by FDI in strategic (high-tech) industrial sectors: consequently, the bulk of current theories consider the role of domestic public agency as marginal for explaining how these economies integrated regional and global markets, even less for explaining the competitive performance of these sectors over time. We argue that this perception is rooted in the assumption that FDI and MNCs played similar roles in a given sector in similar sub-regional economies: That may be true in technology-intensive industrial sectors where MNCs were the only available sources for accessing proprietary technologies and thus the integration of MNC supply chains – what Sceanovic calls hyper-integrationism – was the only available strategy for integrating domestic sectors to transnational markets... leading to similar developmental outcomes. However, in sectors where accessing financial assets proved more important for developmental upgrading than technology, different modes of transnationalization were available.

While we consider it a notable contribution to single out that the transnationalization of a given sector in similar sub-regional varieties of CEE capitalism could actually take on dramatically different shapes leading to widely different developmental outcomes – the deeper question remains: *why* did these two states follow different modes of transnationalization yielding different outcomes?

Following in the footsteps of Peter Evans, developmental models can be understood as depending on three variables: (1) The capacities and organization of the state at the sector level, (2) The capacities and organization of non-state actors at the sector level, and (3) State-society relations. State capacities account on the one hand for the state's Weberian administrative capacity, but also for the *sectorial state's* institutional organization: the latter is more useful for us since Poland and Hungary didn't have fundamentally different administrative capacities but very different segments of the state were in charge of overseeing the transformation of the dairy sector. Non-state actors' capacities and resources depend on their sector-level organization and political

representation, but also on inclusive property right regimes: Inclusive property right institutions offer considerable economic and organizational resources for domestic actors to defend their interests vis a vis the state or MNCs. In the case of the dairy sector, producers' processing cooperatives clearly represent a more inclusive property right regime than a segmentation of the supply chain where producers are only segmented suppliers to processors and retailers. Finally, Evans has long singled out the role of interest coalitions between state and non-state actors in determining developmental pathways in developing countries: his earlier work had stressed the capacity of developing states to steer developmental coalitions with (private) domestic and foreign actors (Evans, 1979). In his later work, Evans explicitly linked this agenda with the rich theme of *coproduction*: In his book *State-Society Synergy – Government and Social Capital in Development*, he concluded from a series of case studies that public goods and public services such healthcare, education, waste management or irrigation necessitate the mobilization and coordination of public and private actors and resources (Evans, 1997; Ostrom, 1997) . In this framework, the existence of stable coalitions and a form of mutual dependency between state and domestic non-state actors are necessary prerequisites for successful economic upgrading strategies: domestic firms might depend on the state's willingness and capacity to harness foreign capital and technology for upgrading domestic competitiveness, but the state is equally dependent on the cooperation of domestic private actors to monitor the implementation of developmental programs and serve as an informational feedback loop (Evans, 2008). This research agenda is useful for us in highlighting the role of developmental coalitions in steering different developmental pathways in Poland and Hungary: we argue that in Poland, a developmental alliance between the state and dairy cooperatives efficiently coproduced developmental upgrading, while in Hungary, the disintegrative effect of the state on the sector weakened domestic non-state actors, thus precluding the possibility of a domestic developmental alliance.

Different developmental coalitions sustaining different policy choices were also shaped by differences in institutional histories affecting the organization of the state at the sector level: In Poland, the collectivization of agriculture under state Socialism was halted in 1956 under Gomulka's leadership, when it became clear that the opposition of farmers could prove fatal for the Communist Party's grip on power. As a consequence,

previous policies of Sovietization were abandoned. This had immediate consequences on the dairy sector. In 1951, pre-existing dairy cooperatives had been nationalized by the state, but in 1957, the Party backtracked: farmers' cooperatives were re-instated. In Hungary, the collectivization of agriculture had been far more advanced: in the dairy sector, processing companies were nationalized and became state property under the supervision of a sector-level Dairy Trust: farmer cooperatives had no direct ownership of dairy processing plants unlike in Poland. This historical difference became important in 1989, when the two countries faced similar problems: In Hungary, the Ministry of Finance had the ability to transfer dairy processing companies from the Dairy Trust to a newly created State Asset Management Agency (AVU). It faced no opposition from farmers, since these firms had been an exclusive property of the state. The objective of the Ministry of Finance was simple: it sought to privatize all accessible assets as quickly as possible in order to finance the foreign debt service. Dairy processing firms fell in the first group of state-owned assets that were privatized in 1993. In Poland, the state didn't own dairy processing plants directly as these belonged to farmer cooperatives, consequently, even though it had the legal capacity and option to dismantle the cooperatives by changing their legal form, it would have faced the ire of a well organized social group of 48 local dairy cooperative unions controlling 10 000 collection points and owning directly 700 processing facilities (FAO, 1994, p.8) – as well as the resistance of a strong Polish Peasant Party (PSL), led by Waldemar Pawlak. While foreign creditors emitted reserves over what they considered a slow and incomplete privatization of agri-food sectors and urged the Polish state to privatize key food processing sectors such as dairy, public authorities chose instead to sanctify the cooperative format as a legitimate form of private property: soon, this form of benign neglect turned into a full-fledged cooptation when the roadmap for the sector's modernization was co-drafted by the state and domestic cooperatives.

From the perspective of dairy, the sectorial state in Hungary was represented by the Ministry of Finance, which had a minimal stake in the sector's long-term developmental perspective, and saw no harm in fragmenting the sector by selling the processing segment to MNCs in order to finance the debt service. In Poland on the contrary, the key state administration in charge of the sector was the Ministry of Agriculture, which had neither the capacity nor a stake in dismantling integrated producer-processor

cooperatives. The capacities and resources of non-state actors diverged accordingly: in Hungary, the combined privatization of processing plants to MNCs and the incapacitation of producer cooperatives as a result of a poorly designed land privatization program managed by the Smallholders' Party single-handedly weakened both the political representation of domestic actors and the property right regime of the sector. An exclusionary property right regime created an economically weakened class of farmers, divorced from the processing segment transferred into foreign ownership, while the political representation of farmers' interests gradually collapsed as the Smallholders' Party lost credibility in the aftermath of a disastrous land privatization agenda. In Poland on the contrary, the political representation of farmers by the Polish Peasant Party (PSL) throughout the 1990s was mutually reinforced by a stable and inclusionary property right regime based on integrated producers' processing cooperatives (in dairy at least). As a consequence, while a developmental alliance between the sectorial state and non-state actors proved structurally impossible in Hungary, in Poland on the contrary the sector's steady competitive upgrading was co-produced precisely by a voluntaristic Ministry of Agriculture (soon joined with a host of public developmental funds and regulatory organizations) and domestic farmers-processors, who were coopted by the state and could actively serve the dual developmental role of providing an informational feedback loop to public officials and as active partners in policy implementation –two crucial roles underlined by Evans (2008).

Overall, we believe that this framework inspired by Evans is able to explain both why the two developmental pathways coalesced in fundamentally different structures, and also how the defining interest coalitions in the two countries embraced increasingly diverging policies in relation to (1) the sector's capitalization, (2) the reform of property right institutions (privatization) and (3) the use of regulatory instruments. The different developmental pathways of Polish and Hungarian dairy sectors were thus not only determined by different domestic policy choices in managing the sector's restructuring, but the state's preference for a developmental strategy closely resembling 20th century "autonomism" in Poland and an "integrationist" Hungarian model can only be understood in light of different actor coalitions and rationalities activated by different historical institutional legacies. In that sense, we consider that alongside divergence in Evans' three core variables of (1) state capacities and organization, (2) private capacities

and organization, as well as (3) state-society relations, the question of historical institutional legacies in the *longue-durée* should be understood as a complementary scope condition in the emergence of two diverging developmental models, as it had indirect consequences both on which part of the state would be in charge, but also on the pre-1989 distribution of property between state and non-state actors. Even a preliminary glimpse at developmental outcomes (as mentioned in the preceding chapter) demonstrates that the two modes of transnationalization did not yield comparable developmental benefits: Poland's autonomist strategy resulted in an increased competitiveness of the sector, where the primary beneficiaries were domestic dairy cooperatives owned by farmers. Hungary's integrationist pathway resulted instead in collapsing competitiveness and (initially at least) a complete marginalization of domestic actors.

Chapter 3.

In the previous two chapters, we proposed a theoretical framework for capturing how different domestic policy choices might explain widely different developmental pathways in Polish and Hungarian dairy sectors throughout the post-1989 decades. In this chapter, we propose an overview of the Hungarian case study. We argue that rather than building an institutional framework, which could have integrated the different domestic actors of the supply chain as happened in Poland, the Hungarian state played an active role in the disintegration of the sector in the course of early privatization: Firstly by subtracting the processing segment of the supply chain where it had direct ownership over processing plants, and selling them independently to foreign investors, the state foreclosed the very possibility of an inclusive developmental coalition with domestic actors and severed ties between farmers-producers and processing firms. Second, by reshuffling property rights in the production segment, it atomized farmers and left them without an ability to mobilize or represent their interests. It is in this context of a fractured vertical supply chain, with weakened domestic actors that MNCs invested overwhelmingly in the processing and retail segments. Instead of playing a positive upgrading role by compensating for the lack of domestic capacities, MNCs instead depleted the remaining resources of the sector. The trajectory of the sector throughout the 1990s and early 2000s is unambiguously negative: domestic actors were largely marginalized in both the production and processing segments. Furthermore, predatory MNC strategies precipitated a value added downgrading of the sector and aggravating trade deficits. On that basis, a new era opened up with the 2010s, when a coalition of domestically owned processors, the state and domestic retail chains sought ever more openly to force MNCs in processing and retail out from the domestic market. The *re-domestication* of the market is a process legitimized by the defense of domestic actors against predatory MNCs: however, farmers remain conspicuously absent from the new interest coalition. In a first section, we present the sector's downward developmental trajectory through a series of indicators. The second section provides a brief historical and institutional context to the sector's restructuring in the early 1990s. In a third section, we discuss the privatization of the sector and the ensuing strategies of

MNCs and domestic firms in the market, to understand why MNCs didn't play an upgrading developmental role. Finally, we examine the state's role in re-regulating the market in tandem with domestically owned processors and retail chains to explain the process we call re-domestication.

Part 1. Developmental Outcomes in the Hungarian dairy sector

The Hungarian sector's performance is largely negative both in relation to its overall competitiveness and in terms of the inclusiveness it afforded to domestic actors as a result of privatization policies, which left producers vulnerable and transferred processing plants to MNCs. Hungarian dairy typifies what Amsden called an integrationist developmental strategy: that is, a particular mode for integrating transnational markets through FDI and the supply chains of MNCs, which are expected to provide domestic actors with the financial capital and technology they lack. In this sector however, MNCs failed entirely at playing a positive upgrading role: contrary to the expectations of Swinnen et al. who consider FDI as a primary driver of competitive upgrading in CEE dairy sectors (Dries & Swinnen, 2004), we show here that the Hungarian dairy sector experienced instead a steady process of competitive downgrading, accompanied by the marginalization of domestic farmers and- (up until the 2010s) of domestically-owned processors.

Foreign and domestic ownership in the Hungarian dairy supply chain

Until 1989, only one central, state-owned processing company existed: the Dairy Trust accounted for 85% of dairy processing, producer-processor cooperatives (processing plants legally owned by farmer-producers) had a 7% share and jointly-owned processing plants by the state and by producer cooperatives accounted for 8% (Jansik, 2000b, p.121). Foreign capital participation was virtually non-existent until privatization. The situation changed quickly after 1990: Although the first brownfield investment only occurred in 1992, the ownership structure in the processing segment was already widely different by the end of 1993 after the state had disbanded the Dairy Trust in 1991 and began selling the processing companies it had controlled through the National Asset Management Agency (ÁPÜ, later ÁV, later ÁPV Rt.) – essentially a

privatization agency: In 1993, state ownership in processing still represented 43,7%, but foreign ownership increased to 40% only a year after the first foreign investment, while domestic private ownership stood at 4% and domestic cooperative ownership at 5% (K. Szabó, 2010, p.12). Throughout the 1990s, the state's direct ownership in dairy processing diminished further as foreign investors continued purchasing state-owned processing plants. By 2000, the state had no direct ownership left in the processing segment whatsoever. The second half of the 1990s and early 2000s marked the zenith of foreign ownership in dairy processing: foreign capital participation in the sector's registered capital accounted for 58,9% in 1997, 80,5% in 2000 and 87,4% by 2004 (AKI, 2009; Szajner & Vőneki, 2014a). In spite of this trend, MNCs began leaving the Hungarian market by the end of the 1990s. The reasons for this shift are discussed in a subsequent section on MNC strategies: this trend encouraged domestically owned dairy processors to strengthen their position by re-purchasing processing plants left behind by MNCs. Today, the two biggest domestic processors, the SoleMizo group and Alföldi Milk – control 50% of processing.

Although food retail comprises a sector of its own, it is also functionally the third segment in the dairy supply chain. While a holistic overview of the retail sector's transformation would largely overstretch the scope of this thesis, a brief overview of the relation between MNCs and domestic firms in the sector is necessary for understanding the emergence of a domestic alliance largely hostile to foreign MNC retailers. Contrary to Poland, MNC retailers played an important role in Hungary by “helping” (indirectly) to establish a coalition of Hungarian public and private actors – directed against them. Contrary to dairy processing, the role of foreign investors in retail was more asymmetrical: MNCs first entered Hungarian retail in the 1991-1994 period. They stabilized their position on the domestic market by introducing two distinct retail formats that had been unknown previously: British and French firms introduced large super- and hypermarkets where economies of scale could be efficiently exploited. German firms on the contrary specialized in discount and cash and carry stores: this model utilizes smaller stores with minimal stocks, extremely rapid turnover and a central procurement system where the basic product types are largely sourced from the MNC's home market – which allows these firms to have very aggressive pricing strategies. MNCs concentrated an increasing share of the retail sector's capitalization

and profits: by 2003 they accounted for 82% of the sector's capitalization (Tímár, 2004). Concentration has been another defining feature in retail: the four biggest retailers controlled 60% of food retail in 2004. In spite of this trend, Hungarian retailers have never been entirely marginalized: three domestic retail chains (CBA, COOP and Real) emerged on the ruins of Socialist retail privatization in 1991 and adapted by specializing in small proximity grocery stores¹⁶. Although the profitability of Hungarian retailers is substantially lower than MNCs' due to a larger network of shops, these three retailers nonetheless control more than 40% of the market today (see Table 3.1), which leads to particular tensions between domestic and foreign firms in food retail.

Table 3.1. Food Retail Chains in Hungary by Rank in 2014

Rank	Origin	Turnover (bn. HUF)	Total Nr. Stores	Turnover/Store	Dominant Format Store Nr.
TESCO	UK	715	209	3,42	Hypermarket (112)
Coop	HU	560	5370	0,10	Grocery (4950)
CBA	HU	505,5	2289	0,22	Grocery (1138)
Spar	NL	473,7	419	1,13	Supermarket (363)
Reál	HU	379	2300	0,16	Grocery (1700)
Auchan	FR	326	19	17,16	Hypermarkets (19)
Lidl	GER	311	163	1,91	Discount (163)
Penny Market	GER	207,2	197	1,05	Discount (197)
Aldi	GER	112,1	100	1,12	Discount (100)

Source: Nielsen

Standard compliance and qualitative upgrading

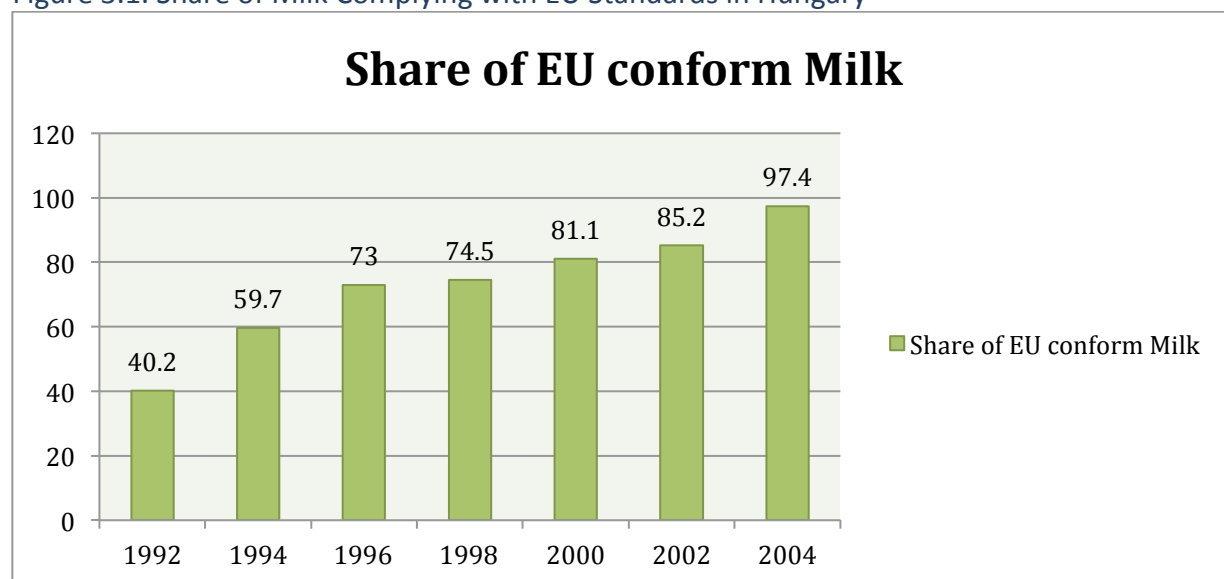
A key argument of Swinnen et al. is that MNCs contributed substantially to the qualitative upgrading of the dairy sector throughout the CEE region, particularly in

¹⁶ CBA has a rather different strategy: while COOP and Reál are overwhelmingly specialized in small proximity stores, CBA attempts to diversify in all formats – even super- and hypermarket stores.

upgrading the quality of fresh milk (Dries & Swinnen, 2004; Dries & Swinnen, 2005). This argument is based on the findings of a large scholarship we discussed in the previous chapter - one which argues that MNCs can be powerful actors of competitive upgrading especially through vertical linkages vis a vis their own domestic suppliers: by virtue of their buyer power, MNCs are in a position to enforce the adoption of stringent public or private product standards among their suppliers. From a developmental perspective, the adoption and diffusion of modern food safety standards such as ISO 9000 and HACCP (both of which are mandatory inside the EU) might open up new export markets, where these standards function as non-tariff barriers to trade. In that regard, where food safety standard diffusion and compliance effectively improves the quality of the raw material (fresh milk), one might expect strengthened export competitiveness. To the extent that MNCs have played an overwhelming role in the processing (and retail) segments of the sector after 1990, Hungary offers an apt case for re-assessing this argument.

On the one hand, the adoption and diffusion of EU food safety norms indeed showed steady progress throughout the 1990s to the point where by 2004, at the time of EU accession, the overwhelming majority of milk produced in Hungary had already been compliant with the stringent standards of the EU (figure 3.1.).

Figure 3.1. Share of Milk Complying with EU Standards in Hungary



Source: Hungarian Dairy Research Institute (*Tejgazdasági Kísérleti Intézet*)

However, two facets of qualitative upgrading through standards fundamentally qualify this picture: On the one hand, standard adoption and compliance raise distributive problems, as farmers and processors unable to secure the capital necessary for technological modernization and standard compliance are likely to be excluded from the sector if they can't find buyers for their sub-par products (Berdegue et al., 2005; Dries & Swinnen, 2004; Dunn, 2003). In that regard, the positive gains in export competitiveness at the sector level have to be put in perspective with the degree of social exclusion that adjustment entails for domestic actors. The potentially negative developmental effect of standard adoption on social inclusiveness has been underlined by Lee et al. (Lee et al., 2010), while Bruszt and Langbein (2014) have specifically underscored that EU food standard adoption was an important factor in the concentration and social exclusion of dairy producers in CEE¹⁷. In that regard, the Hungarian dairy sector's steady and swift alignment to EU standards throughout the 1990s – while certainly positive - has to be qualified by the social cost it entailed – as discussed further below.

Second, while the correlation between standard adoption and gains in competitiveness might be theoretically appealing, the Hungarian case shows a different picture: besides social costs, the qualitative upgrading of fresh milk cannot overshadow the fact that at the trade and production level, the Hungarian dairy sector in fact experienced a steady and grave process of value added downgrading and a collapse in export competitiveness - in spite of satisfactory milk quality.

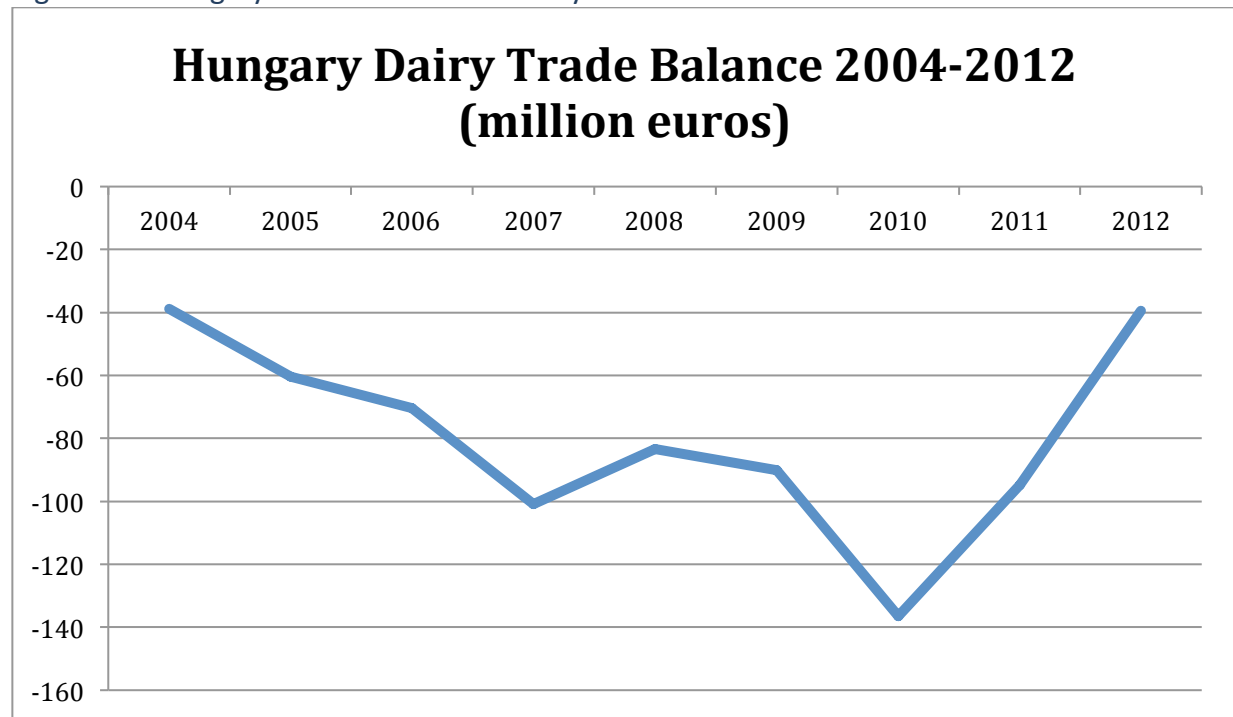
Trade performance: aggravating trade deficits and value added downgrading

The competitiveness and profitability of the Hungarian dairy market has substantially eroded over the last two decades: The situation is so severe that the Milk Council (the only sector-level organization in the sector) has commissioned the Hungarian Institute of Agricultural Economics (AKI) to produce an exhaustive overview of the sector in 2014 in order to identify policy alternatives for avoiding an overall collapse. The document

¹⁷ More precisely, standard compliance represents an objective cost, however the exclusion of domestic farmers and processors occurs when neither MNCs nor domestic public and private financial venues for accessing the capital necessary for modernization investments materialize. In that sense, the degree of social exclusion is always mediated by the existence or absence of foreign and domestic financial resources.

painted a bleak picture: Production decreased from an average of 2850 tons between 1986 and 1990 to an average of 1812 tons in 2012. Domestic consumption of dairy products per capita decreased from 200kg per year in 1987 to 150 kg in 2013. The trade balance of the sector went from a surplus of 25 million euros in 2003 to a deficit of 140 million in 2010: The Milk Council remarked that this situation was all the more paradoxical given that the quantity of exported and imported milk and dairy products had been virtually equivalent in recent years (876 000 tons exported and 787 000 tons imported in 2011): in other words, the Hungarian market is potentially self-sufficient, however its trade integration to transnational markets, chief of which the EU, and more specifically the CEE regional market, has proved financially disastrous (Terméktanács, 2013, p.6).

Figure 3.2. Hungary's Trade Balance in Dairy Products 2004-2012



Source: AKI

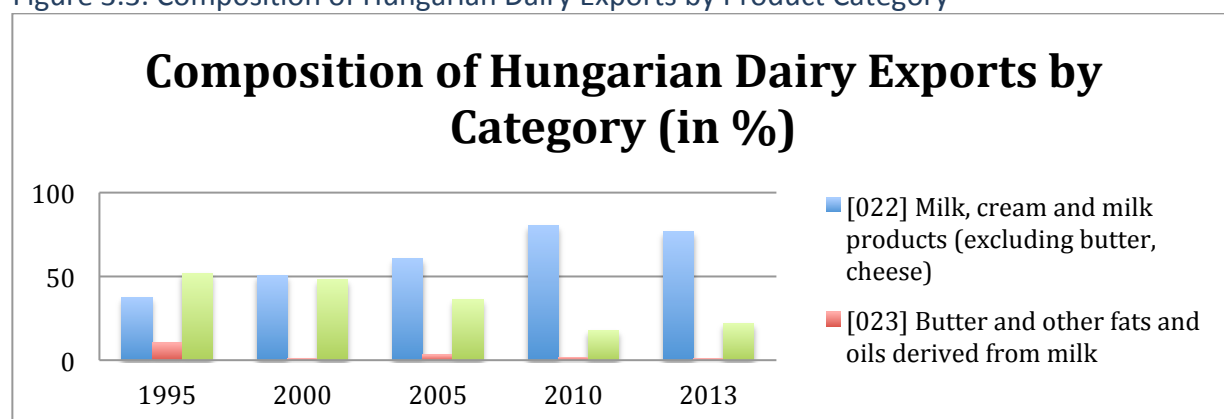
The erosion of competitiveness is evident from an aggravating trade deficit accumulated since EU accession in 2004. Jansik (2000) and Jám bor (Jambor, 2011) both noted the negative consequences of EU accession for the Hungarian dairy sector: since dairy exports played a lesser role in the strategies of MNC processors throughout the 1990s, the product portfolios of processors aligned with the established tastes of Hungarian

consumers instead of introducing new, innovative products: the predominance of processed cheese is a notorious example¹⁸.

After EU accession in 2004, imports soared especially in the type of premium, higher value-added products that didn't have a counterpart on the domestic market. The competitive shock of EU accession was aggravated by the bottleneck on potential export markets as a result of the 2007 financial crisis: Hungarian milk and dairy products were in direct competition with all other CEE new member states for EU15 markets at a time when the Hungarian sector didn't have strong comparative advantages relative to its neighbors and when demand contracted severely on Western markets as well.

Breaking down exports and imports by value added shows a clear trajectory since the early 1990s, namely a steady collapse in the share of higher value added dairy products: by 2013, 76% of dairy exports were concentrated in fresh milk, cream and powder – the lowest value added products in the industry. Even in the 1990s, when the sector was suffering from an overnight loss of traditional Socialist export markets, cheese and curd (higher value added goods) had still accounted for more than 50% of total dairy exports (see Figure 3.3.).

Figure 3.3. Composition of Hungarian Dairy Exports by Product Category

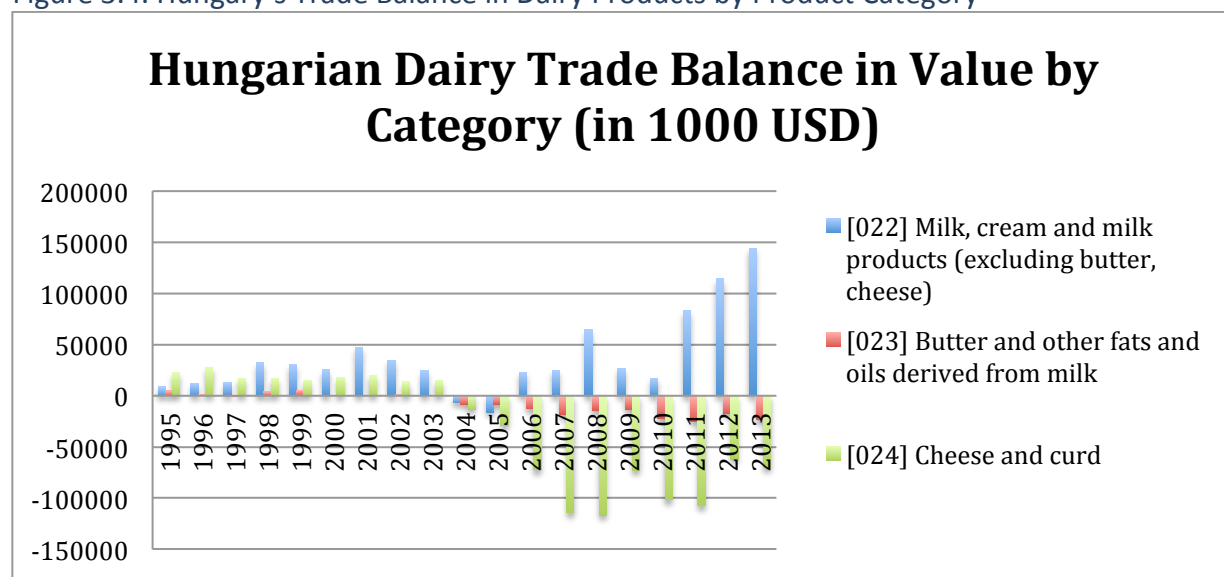


Source: UNCTAD

¹⁸ Processed cheeses are cheap and relatively unsophisticated goods created from dairy byproducts. During state Socialism it was predominant cheese product due to low production costs: during the 1990s however when higher value added premium fermented cheese types would be imported, dairy processors in Hungary didn't exploit the new market niche and continued to rely on an established domestic demand for processed cheese.

Figures 3.4 and 3.5 capture the erosion of value-added downgrading: it is particularly remarkable to observe that 2004 (EU accession) marks a turning point, which boosts manifold the negative trend that had been underway throughout the 1990s: trade deficits in higher value added goods such as cheese, curd and butter soared immediately after EU accession, while the sector gradually specialized in the export of fresh milk, cream and powder.

Figure 3.4. Hungary's Trade Balance in Dairy Products by Product Category



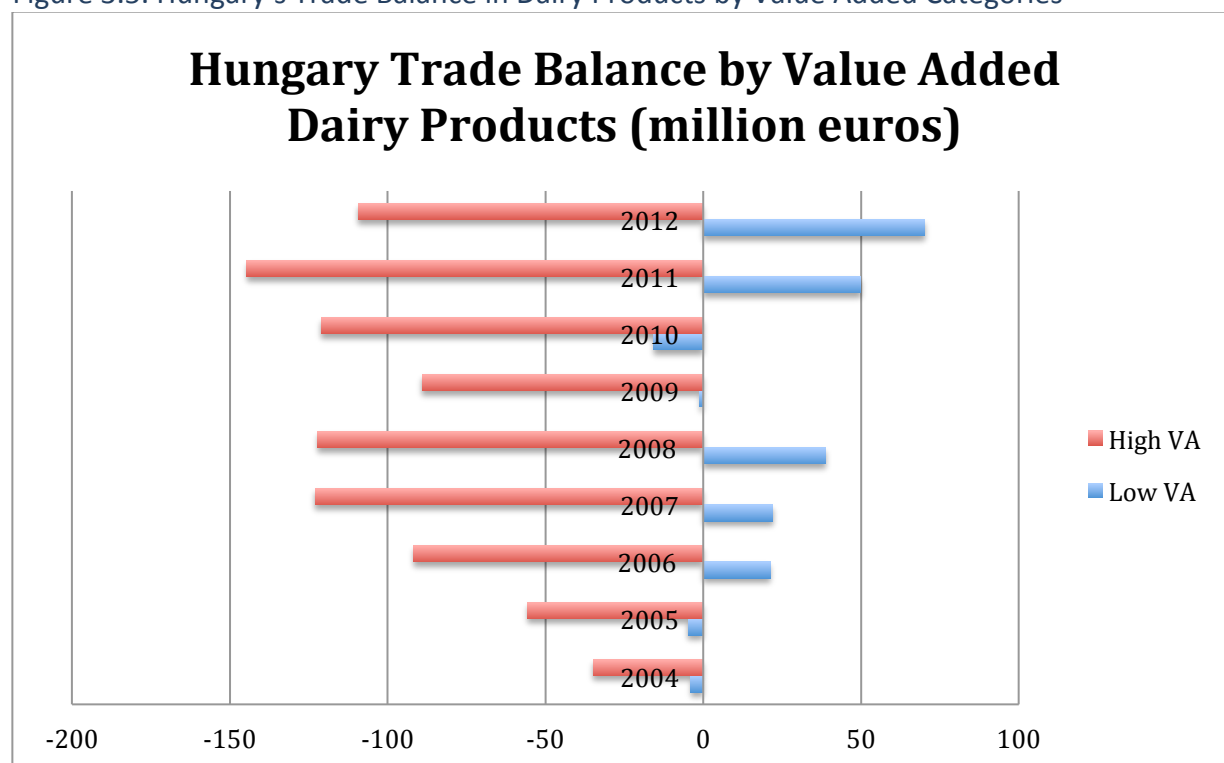
Source: UNCTAD

This graph might suggest that in spite of value added downgrading, the trade deficit in higher value added products was compensated for by a surge in fresh milk exports but the graph only accounts for the three main types of dairy products registered in the UNCTAD database. When considering a wider range of products, it becomes evident that this was not the case, as shown in Figure 3.5: for instance in 2012, a trade surplus of 70 million euros in lower value added products was entirely consummated by a trade deficit of 109 million euros in higher value added goods.

Although the trade deficit, which has been a constant characteristic of the Hungarian dairy sector since EU accession remains, the 2011-2013 period shows a rebound after the 2010 low point when the sector had reached a record deficit of 136 million euros (with deficits in virtually all product categories). By 2012, the deficit “reached back” to 40 million euros, however the imbalance between a severe deficit in high value added

products and modest gains in the export of raw material (fresh milk) remains as seen below.

Figure 3.5. Hungary's Trade Balance in Dairy Products by Value Added Categories



Source: own calculations based on KSH and UNCTAD data. (Higher VA products: cottage cheese, kefir, cheese, yoghurt, sour cream, butter. Low VA products: whey, fresh milk, cream and powder)

It is also worth examining the place of the Hungarian dairy sector in relation to other CEE markets: as noted during our interviews with experts¹⁹, Hungary occupies a peculiar place in the regional distribution strategies of retail and dairy processing MNCs: Hungary is a market where the surplus created in other EU15 and CEE markets - Poland notably – has been sold below Hungarian production costs²⁰.

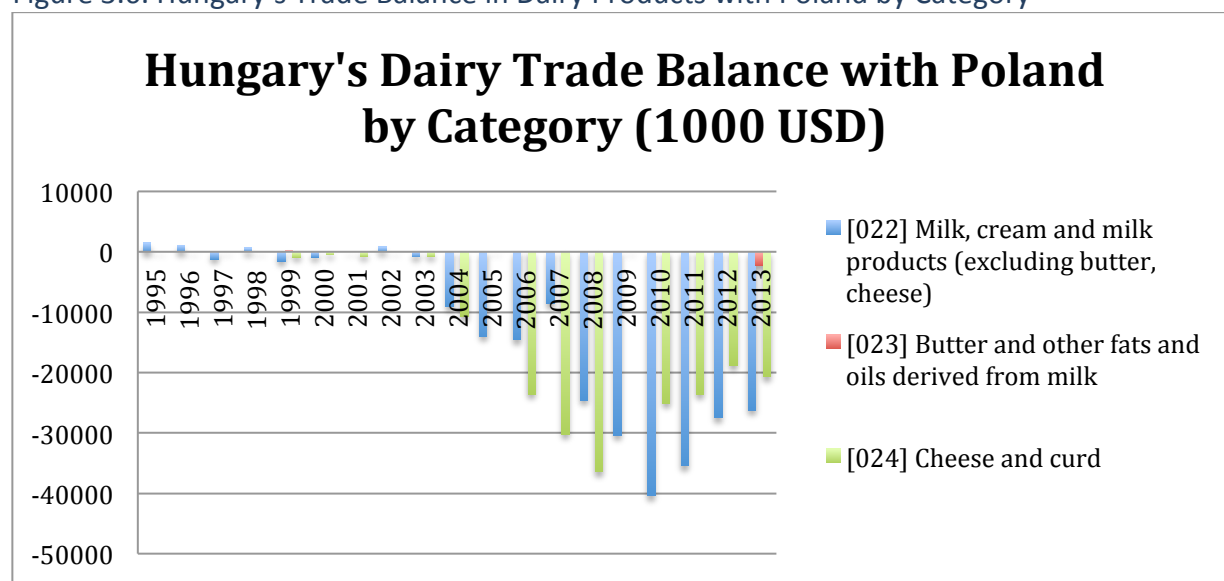
Figure 3.6 illustrates the effects of EU accession (in 2004) on trade relations between Hungary and Poland: what is surprising is not the trade deficit per se – an outcome of a disadvantageous low value-added production structure as detailed above – but the fact that Hungary has become a net importer of Polish fresh milk and lower value added

¹⁹ Interview with Dr. Fórián, Agrár Európa, 12/11/2013

²⁰ A practice later banned by new regulations as discussed in the last section of this chapter on the public re-regulation of the dairy sector.

dairy products as well (product category 022). In other words, the regional organization of dairy trade in CEE has established a pattern where the Hungarian market is predominantly not export-oriented, but rather serves to supply domestic demand: however, in the face of new export powerhouses such as Poland, Hungarian producers and processors also lose their market share on their own market, even in the lower value added products such as fresh milk when the surplus created in regional competitors can be imported below Hungarian production costs.

Figure 3.6. Hungary's Trade Balance in Dairy Products with Poland by Category

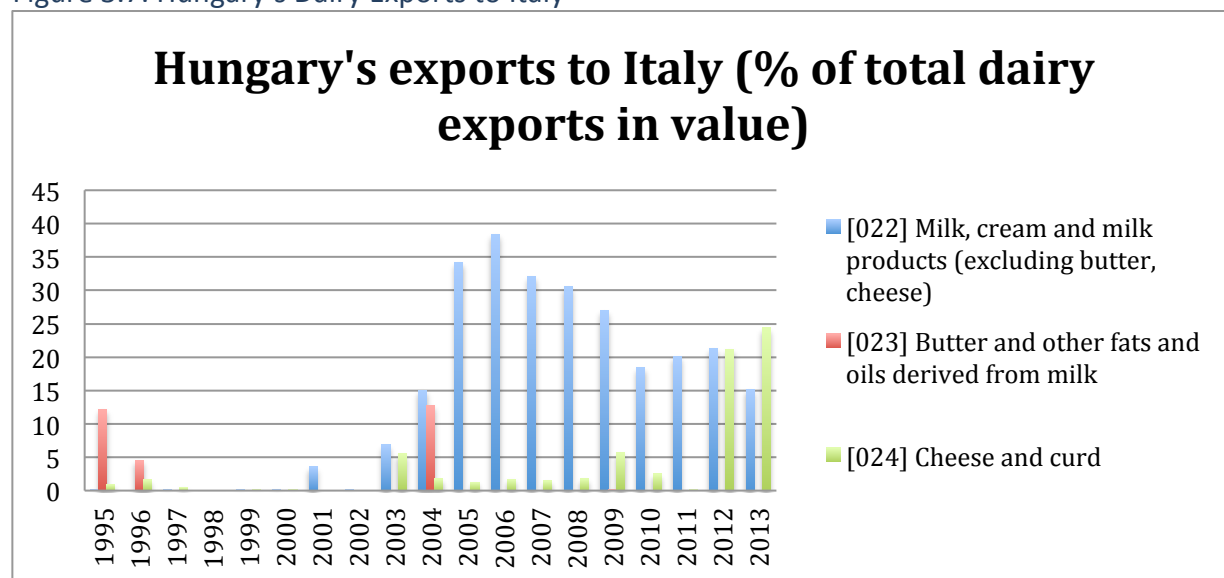


Source: UNCTAD

In spite of the severe problems facing the sector, there are also timid signs of an amelioration over the past four years: the trade deficit in higher value added products shrank from 144,6 to 109 million euros between 2011 and 2012, while the overall trade deficit in dairy products more than halved from 94 million euros in 2011 to 34 million euros in 2012. Italy being the single biggest export market for Hungarian dairy products, if one examines Italy's position in Hungarian dairy exports by product type, it is also apparent that Italy has progressively absorbed an increasing share of higher value added goods: while in 2006, 38% of Hungarian fresh milk exports were destined to Italy with virtually no exports of cheese, by 2013 Italy only accounted for 15% of fresh milk exports but 24% of total cheese exports as shown in Figure 3.7. This relative amelioration in the trade patterns of the sector were unanimously recognized in the interviews we conducted, however, experts also warned that given the important

changes expected on EU dairy markets after the 2015 phasing out of national production quotas in place since 1984, it is too soon to extrapolate from the trend of the past few years²¹.

Figure 3.7. Hungary's Dairy Exports to Italy



Source: UNCTAD

The competitive downgrading of Hungarian dairy trade singles out two notable patterns: Firstly, the gradual value added downgrading of Hungarian dairy production and exports. This trend is apparent in the individual strategies of MNCs throughout the 1990s and early 2000s: the primary aim of MNCs was to build a domestic demand for their products: in a subsequent section of this chapter, individual firm strategies are discussed in more detail to shed light on a general pattern in MNC strategies that primarily focused on building and sustaining demand on the domestic market: neither the establishment of a rational and financially sustainable production structure, nor exports figured among the primary goals of MNCs. What is more, chaotic acquisition and merger strategies also had a dramatic effect on both value added downgrading and disorganization within supply chains as discussed later.

In the regional organization of dairy trade that emerged in the course of the 1990s, markets such as Poland became export powerhouses, while other such as Hungary were

²¹ Interview with Dr. Fórián, Agrár Európa, 12/11/2013

of interest to MNCs for capturing a small domestic market and stabilizing regional supply by playing the role of a dump market where excess production from regional competitors could be unloaded. In light of these, neither aggravating trade deficits nor value added downgrading are surprising outcomes.

Concentration and exclusion in the production segment: Gains in productivity at the expense of small producers

The collapse in export competitiveness is not an isolated weakness of the Hungarian sector but reflects instead a general pattern in CEE. The Hungarian dairy sector displays three main trends at the production level: (1) substantial concentration and exclusion of the smallest and least competitive domestic actors in the production segment, (2) a reduction in outputs produced, and (3) strong gains in productivity as a result of concentration.

Table 3.2. Dairy Farms and Cow Herd in Hungary 1989-2002

	1989	1995	2000	2002
Nr of Dairy Farms	28930	26310	25986	20806
Nr of Cows ('000)	658	423	380	367
Milk Production (mn. Liters)	2779	1920	2081	2068

Source: Milk Council

Concentration at the production level has been a general phenomenon in CEE throughout the transition period, and is still underway. The restructuring of the dairy production segment had to face two fundamental shocks: the first consisted in the 1989-1991 Communist collapse when land-, processing- and retail were largely privatized all the while CEE countries lost access to their traditional COMECON export markets and the pre-existing sector level coordination as well as Socialist intervention policies were terminated. The second challenge was EU accession in 2004, after which CEE markets faced fiercer competition on both domestic and export markets.

At the production level, what is apparent is that the exclusion of domestic producers substantially accelerated in Hungary after EU accession. In other words, EU accession proved even more detrimental to dairy producers than the regime change in 1989: While the number of dairy farms decreased by a third in the first decade of transition

(Table 3.2.), the number of registered dairy farms was further halved between 2002 and 2012 as shown in Table 3.3.

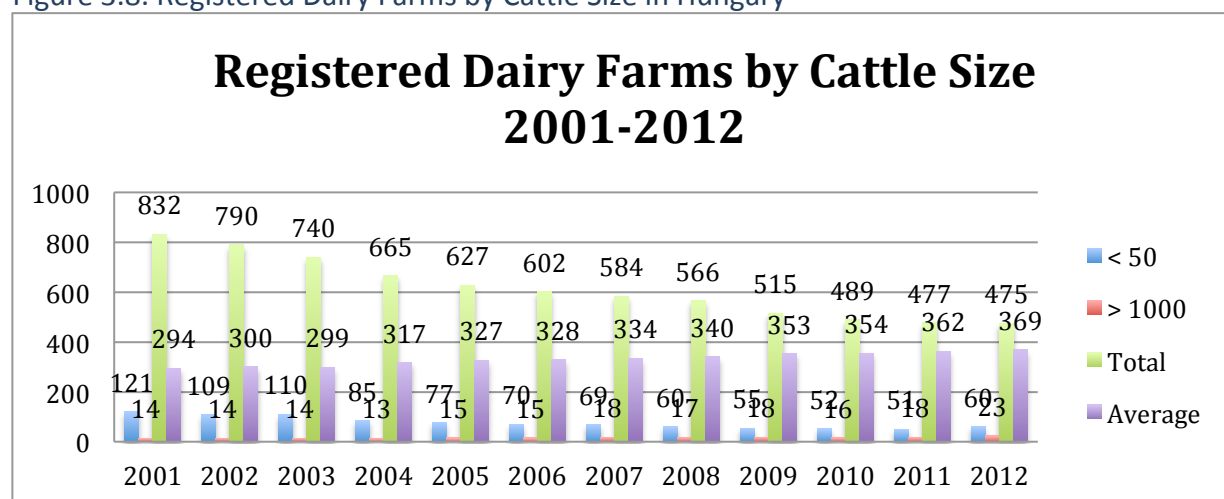
Table 3.3. The Structure of Registered Dairy Farms by Cattle Size in Hungary

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
< 50	121	109	110	85	77	70	69	60	55	52	51	60
51-100	116	99	86	66	69	70	65	66	60	54	52	40
101-300	252	248	220	211	193	181	173	163	148	138	135	131
301-500	195	191	192	164	153	148	145	144	125	125	116	120
501-600	70	56	52	56	48	56	55	56	51	41	41	42
601-700	26	32	34	38	37	31	28	28	22	25	26	25
701-800	20	25	18	17	18	13	13	11	13	17	13	13
801-1000	18	16	14	15	17	18	18	21	23	21	25	21
> 1000	14	14	14	13	15	15	18	17	18	16	18	23
Total	832	790	740	665	627	602	584	566	515	489	477	475
Average	294	300	299	317	327	328	334	340	353	354	362	369

Source: AKI

This process was also asymmetrical in as much as small producers were the primary victims of concentration, while the size of the average dairy farm grew steadily (see Figure 3.8).

Figure 3.8. Registered Dairy Farms by Cattle Size in Hungary



Source: AKI, Hungarian Milk Council 2013

The specificity of the Hungarian pathway is best captured when put in perspective with other CEE countries, chief of which Poland. In the latter, the 1990s were equally marked by the exclusion of dairy farmers, but this process was not as drastic as in Hungary. Two points stand out in particular: both the 1990s and the post-EU accession period were

less exclusionary for dairy producers in Poland than in Hungary. Compared to Hungary, which lost a third of its dairy farms in the first decade after 1989, Poland registered a decrease of “only” 15% (although in absolute terms, this accounted for more than 200 000 farms).

Table 3.4. Evolution of Polish Dairy Farm Size Structure in the 1990s (thousands of farms)

Cows/Farm	1987	1996	1997	1998	1999	2000
1 to 2	979	910	899	863	871	866
3 to 5	407	250	240	247	225	211
6 to 10	76	127	126	136	127	125
>11	7	21	26	21	33	49
Total	1468	1307	1290	1266	1256	1251

Source: (Jongeneel & Longworth, 2005, p.11)

In the post-EU accession period, Hungary experienced a similar trend to Slovakia and the Czech Republic, as in all three countries the elimination of less competitive smaller producers is a process still underway. The Czech Republic saw the number of its registered dairies halved (-52%) only between 2002 and 2010, Slovakia registered a decrease of -44% and Hungary -37%. It is worth noting that in spite of the tremendously fragmented nature of Polish agricultural land tenure, this decrease proved substantially less dramatic (-13%) – which may seem counter-intuitive: if the current trend of concentration was merely a “rational” answer of the market to eliminate the least productive dairy farms, Poland should have experienced the most dramatic concentration in the number of its farms.

Table 3.5. Number of Registered Dairies in CEE ('000)

	2002	2004	2006	2008	2010
Hungary	804	691	613	578	503
Poland	22182	19167	18046	19090	19323
Slovakia	1015	849	741	717	570
Czech R.	3715	3146	2642	2181	1782

Source: International Committee for Animal Recording (ICAR)

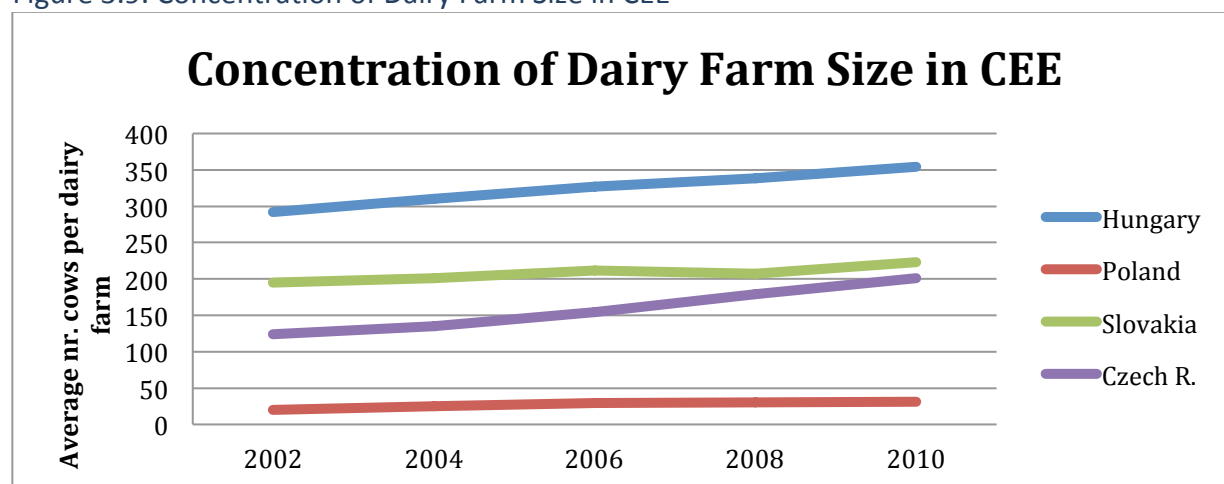
Secondly, the Hungarian trend in concentration actually proved most significant in the entire CEE region: Hungary has the most concentrated production segment among its regional competitors resulting from the elimination of small producers. Today, an average dairy farm in Hungary is tenfold the size of a Polish producer's (Table 3.6).

Table 3.6. Average Number of Cows Per Dairy Farm in CEE

	2002	2004	2006	2008	2010
Hungary	292	310	327	338	354
Poland	20	25	29	30	31
Slovakia	195	201	212	207	223
Czech R.	124	135	154	179	201

Source: International Committee for Animal Recording (ICAR)

Figure 3.9. Concentration of Dairy Farm Size in CEE



Source: International Committee for Animal Recording (ICAR)

The fact that Poland experienced an increase in competitiveness, while simultaneously conserving a large share of its extremely small dairy farms (as further discussed in the next chapter), all the while Hungary - where the average size of farms is the biggest and productivity the highest in the Visegrad region - continues to loose dairies at an alarming rate – all point to the fact that the current transformation underway in CEE dairy sectors is not merely the outcome of a necessary adjustment to free market conditions: the divergence between Hungary and Poland shows on the contrary that a strong improvement in the quality of raw material (fresh milk), combined with large flows of FDI and a rapid concentration in production structures can also go hand in hand with a dramatic collapse of competitiveness and buyer-supplier relations throughout the supply chain. Conversely, the Polish pathway underscores that social inclusiveness and improving export competitiveness can also accommodate a fragmented ownership structure, which is economically less rational and less productive at the individual farm level but socially more inclusive. In other words, the differentiated trends of social

exclusion among dairy farmers between Poland and Hungary reflect institutional differences in the defining property rights institutions of dairy production and processing.

The elimination of small producers in Hungary was accompanied by a reduction in absolute milk production but also by substantial gains in productivity. While the entire CEE region had to confront similar challenges to Hungary (one can observe similarly decreasing trends in Slovakia and the Czech Republic), the reduction in absolute production has been most important in Hungary with a decrease of 20% between 2000 and 2010 alone as shown in Table 3.7.

Table 3.7. CEE Dairy Production in 1000 tons

	2000	2002	2004	2006	2008	2010
Hungary	2143	2130	1900	1849	1846	1690
Poland	11889	11873	11822	11982	12425	12279
Romania	4301	4637	5053	6011	5468	4411
Slovakia	1067	1198	1079	1092	1057	918
Czech R.	2789	2729	2680	2767	2801	2683

Source: AKI 2014

Gains in productivity have been strongest in Hungary in the CEE region over the past two decades, which owes much to the exclusion of small producers in particular, who couldn't upgrade the genetic stock of their herd nor invest in modernizing their machinery and equipment.

Table 3.8. Milk Yields in CEE after EU Accession (Average liter per cow per year)

	2002	2004	2006	2008	2010
Hungary	7449	7753	8122	8554	8660
Poland	5712	6152	6664	6817	6980
Slovakia	4940	5724	6267	6759	6739
Czech R.	6285	6662	7155	7537	7726

Source: International Committee for Animal Recording (ICAR)

One could think that the social cost of exclusion could be offset by the economic gains realized through gains in productivity, however this hypothesis is doubly contradicted: as we mentioned previously, the Polish pathway shows that lesser concentration can actually accommodate competitive upgrading. Second, Hungarian gains in productivity have not translated into a competitive upgrading of the sector: as the indicators on trade

and value added show, the Hungarian sector on the contrary suffers from value added downgrading at the production and trade levels.

Conclusion on developmental indicators: Competitive downgrading and uneven distribution of benefits to the detriment of domestic actors

In the first chapter, we defined developmental outcomes in dependent market economies alongside two dimensions: The first dimension concerns competitive upgrading, the second focuses on ownership structures in the domestic market and the power relations between domestically owned and foreign firms. In light of the indicators and data presented in this section, the developmental trajectory of the Hungarian dairy sector since 1989 can be characterized as following a trajectory of economic downgrading coupled with the exclusion of domestic actors. Surprisingly, the immediate shock in the aftermath of 1989 proved less dramatic than EU accession: 2004 marks a critical juncture after which trade competitiveness virtually collapses, while the exclusion of less competitive smaller farmers accelerates.

In light of this negative downgrading trajectory, the remaining part of this chapter will attempt to clarify on the one hand why, instead of competitive upgrading and a consolidation in the vertical coordination of supply chains, MNC strategies actually resulted in competitive downgrading. On the other, the role of domestic agency will be scrutinized in relation to domestic actors and MNCs. We argue that domestic agency played a crucial role in the sector's developmental trajectory: (1) By determining the level of FDI penetration in dairy processing, (2) by fragmenting the ownership structure of land without investing in the technological modernization of farmer-producers, (3) by disintegrating the supply chain through the privatization of dairy processors owned by the state, and (4) by attempting to "re-domesticate" the dairy market in tandem with Hungarian dairy processors and retailers.

We argue that the Hungarian sector's social and economic performance was conditioned by public policy choices that proved largely detrimental from a developmental perspective: The Hungarian state contributed to the disintegration of the sector by

separating the management of the production and processing segments: the privatization of land and the dismantling of cooperatives deeply weakened producers while simultaneously severing their linkages with processing firms transferred to MNCs in bulk. This ensured that the sector's vertical coordination between different actors of the supply chain would be structurally weakened, all the while no developmental coalition between public and private actors could materialize in a situation where the state, processors and producers had fundamentally different interests.

Part 2. Institutional legacies in the *longue-durée*

The early 20th century: a cooperative-corporatist sector

The Hungarian dairy sector showed a similar historical pattern to Western European and American dairy markets throughout the 19th and early 20th century: even in “core” capitalist economies such as the US and the UK, milk and dairy markets have often been managed directly by the state through corporatist institutions sometimes until as recently as the 1980s and 1990s (Schneiberg, 2011).

In Hungary, a National Dairy Cooperative Center was set up in 1922 by the Ministry of Agriculture, the National Credit Cooperative, the national agricultural cooperative “Hangya” and the joint stock company “Futura” (Tóth, 2014). Hungary, as many other European countries, had an early experience in the grassroots development of producer and marketing cooperatives throughout the 19th century: “Hangya” was the largest of these cooperatives. The administrative disorganization that followed the territorial losses of the First World War provoked a need to reorganize the supply chains and coordination of the sector. Denmark, the leader in agricultural cooperatives would serve as the model for the creation of a National Dairy Cooperative Center (NDCC). The NDCC represented a corporatist structure, progressively absorbing independent “grassroots” cooperatives into a national organization managed from the top by the state, which acted both as shareholder and creditor. The NDCC realized a form of vertical integration by tying together in a single organization the three separate production segments of the dairy supply chain: production, processing and retail were entirely integrated. At the production level, it had progressively absorbed 270 smaller cooperatives by the 1930s

and it gathered 1042 members by 1942 Tóth, 2014). The regionally sourced fresh milk was processed in the NDCC's central Budapest plant, while it also disposed of its own retail channel: it operated more than 60 selling points throughout the country and also supplied a further 700 retailers, many of which were operated by Hangya's retailer cooperatives. The Center marketed dairy products both on the domestic market but also managed exports without intermediaries. Both production and export were heavily subsidized by the state, which continued to offer preferential loans to the organization in spite of recurrent deficits. Overall, the Hungarian dairy sector's organizational structure closely matched the corporatist model of Western European counterparts (Schneiberg, 2011).

Nationalizing dairy under state-Socialism: State and collective ownership

The first critical juncture occurred in the aftermath of the Second World War when agricultural land and processing plants were fully collectivized: the NDCC dissolved into the National Dairy Trust in 1948. All assets owned by the NDCC became state property. Throughout the forty years of state Socialism, the Dairy Trust operated 15 regionally organized dairy companies in which fresh milk production and processing were locally integrated: exports virtually ceased until the 1970s and production shifted almost exclusively to the domestic market. While policy instruments were similar, it is nonetheless difficult to compare public interventions in state Socialist and capitalist economies: on the one hand, the public subsidization of production and consumer prices which typified Hungarian dairy under Socialism shows similarities to the Western European model. However, given the fact that prices didn't reflect actual production costs and the absence of markets in a literal sense in a planned economy makes for difficult comparison: Ultimately, the Hungarian (Socialist) regulation of the market can be best typified by the firm integration of the supply chain- (production, processing and retail) in regional production structures, the elimination of any competition between these regional dairies as well as a subsidization system which heavily supported production, exports and consumer prices.

On the organizational level, collectivization produced specific consequences: at first sight the post-1948 model of sector-level coordination through the Dairy Trust showed a continuity with the pre-war corporatist management of the sector. After all, the state had already played a major role in managing the vertical coordination of the sector from producers to retail and export as well as public subsidies since the 1920s. However, the 1948 collectivization and reorganization of the sector constituted a major turning point: even more important than the disappearance of private capital and the type of public-private partnership which characterized the pre-war NDCC, forced collectivization meant a lack of autonomy at all levels of the production chain, the disappearance of the profit motive, which had incentivized investments and the destruction of social capital and trust. The Dairy Trust cancelled out competition between the 15 regional dairies by drawing geographic boundaries between their markets: there was no competition for consumers between these state owned companies, no necessity for innovation and investments as the entire industry was heavily subsidized and subdued to the imperatives of the seven multi-annual Plans between 1950 and 1990. The dairy sector shifted from the production of a tradable good to an instrument of national food security in the post-War decades.

The most notable attempt at redressing the competitiveness of the dairy sector came in the form of a national cattle-breeding plan in 1972. The program relied on public subsidies conditional on dairy cooperatives to propose a timeline and quantified objectives for increasing outputs, productivity and quality (fat content). However, the fundamental objective of the program was not to increase export competitiveness but to boost domestic consumption. Some argue that the program was a response to problems in the supply chain: dairy cooperatives sourced their fresh milk from small farms whose output couldn't keep up with the urban demand for dairy products during the 1960s: the 1972 program sought to remedy an unstable supply chain reliant on small cattle breeding farms with the intensification and modernization of production in larger farms with closer ties to processing cooperatives (Szalka, 2002, p.17). Others suspect that the program was not driven by an increasing urban demand for dairy products and rather than a solution to supply chain problems, it was primarily an outcome of the sheer lobbying power of dairy processor management on the Ministry of Agriculture to increase the sector's subsidization (K. Szabó, 2010, p.19). Notwithstanding the

underlying motives, and in spite of the inherent limitations of an inwardly expansionist strategy in a small market such as Hungary, the program proved successful in increasing productivity in the production and processing segments as well as expanding domestic consumption.

Between 1975 and 1990, the annual yield of milk per cow doubled from 2500 to 4800 liters, the consumption of dairy products between 1972 and 1987 doubled to 200kg per capita per year (Szalka, 2002). However, unlike the stringent monitoring and punish- or-reward system of conditional subsidization highlighted by Amsden (1989) in South-East Asia , the Hungarian model of subsidization was substantially looser: the purchasing price of milk at the farm gate was subsidized up to 50%, as were infrastructural modernization investments for cattle breeding, export subsidies reached 70% while consumption subsidies driving up demand reached 7 billion HUF in 1987 and amounted to 35% of the consumer price (K. Szabó, 2010). The rapid amelioration in the sector's overall performance was entirely reliant on the public subsidization system but the later shocks experienced by Hungary throughout the 1990s foreclosed this strategy: soaring public debt and structurally heavy current account deficits increasingly limited the margin of maneuver for the state, a process that was further accelerated in the post-1989 liberalization context where the domestic shortage of public capital in conjunction with transnational trade regulations banning state aid (such as the early Europe Agreements, and later the pre-accession process) gradually dried the sources of public subsidies to the sector²².

In the subsequent sections, the effects of privatization and the role played by the state in re-regulating the dairy market throughout the 1990s and 2000s will be examined in more detail. However, in relation to the transformations affecting the sector at the end of the Socialist period, a number of further clarifications are necessary. The first concerns the sector's vertical coordination along the supply chain in late Socialism and in the

²² It should be emphasized that this is not a particularity of Hungary or even post-Communist regimes: very similar processes occurred throughout Latin-American and Asian semi-peripheral regions throughout the late 1980s and early 1990s in the wake of the debt crisis, which marked an abrupt end to autonomist developmental strategies.

immediate aftermath of 1989. The second point concerns the shock caused by 1989 in the pre-existing support policies under state Socialism.

We have already mentioned that the Dairy Trust acted as the state's centralized coordinating agency under Socialism and that the sector was marked by a regional division between separate, integrated supply chains without any competition between them. In this mode of organization, the 15 distinct regional supply chains were organized around a number of central processing plants. The ownership structure of these plants showed some minor variation however: in 1989, 85% of processing occurred in plants that belonged directly to the Dairy Trust (in other words these constituted exclusive state property), 7% were processing plants owned by producers' cooperatives, while another 8% were jointly owned by the Trust and cooperatives. The production segment of dairy had in turn three components: in 1989 state farms represented 21,2%, cooperatives 55,5% and small, independent private farms accounted for 23,4% (M. Szabó, 1999). What it meant in effect was that two different types of property right institutions characterized processing and production: state monopoly in processing and state farms/cooperatives in production. State-owned processors used fresh milk supplied at the regional level by extensive cooperative- and state farms, while a minority of input came from small private farms (Gorton & Guba, 2002). A specificity of Hungarian agriculture and agri-food industries under late-Socialism was the complex interdependency between public and private ownership: a 1967 law on land property formally tolerated smaller private property as a necessary evil, alongside state- and cooperative- ownership preferred by the regime. Cooperative members were thus entitled to keep private plots. In the subsequent decades, a highly complex interdependence emerged between state and cooperative property on the one hand and private property on the other: however, instead of an equilibrium, it led to the emergence of a frustrated class of farmers who were successful in their private plots but couldn't buy machinery nor further land from cooperatives (Hann & Sárkány, 2003; Harcsa, Kovács, & Szelényi, 2003a, 2003b; Varga, 2007). Therefore, while it is true that the Dairy Trust represented a fully public actor with a monopoly on the intra-sectoral organization of the 15 regional supply chains, the production and processing segments were complex assemblages of state-, cooperative- and private property: the restructuring process between 1990 and 1993 proved exceptionally challenging because

while on the one hand the Dairy Trust as an agent of vertical coordination was disbanded in 1991 – land, cooperatives and processing plants were all independently (yet in parallel) transferred from collective to private ownership in the course of the first privatization wave.

The second point concerns the shift in the state's support policies after 1989. As we mentioned previously, in late Socialism, the public subsidization system supported both farmers' production costs but also consumer prices. However, by 1988 the government decided to phase out consumer price subsidies. Thus the key problem of the sector in 1990-91 (besides the thorny question of privatization and property rights) was an overproduction crisis: in 1991, the sector produced 400 million tons of milk in excess, which couldn't be absorbed by domestic demand (inflation only aggravated rising prices after consumer price subsidies were removed) – nor offloaded on export markets: the traditional COMECON export markets were similarly depressed, while accessing Western markets was limited by tariffs and a lack of compliance with Western food standards. As a result, the government improvised new tools for intervention aimed at resorbing overproduction: (1) a subsidy of 10 000 HUF (138 USD) was guaranteed after each slaughtered cow on the condition that the producer would further reduce milk quantities delivered to milk processors by 4500 liters for each killed cow. (2) Export subsidies were raised from 30% to 35%, (3) If producers accepted to reduce delivered milk quantities by 15%, they could continue enjoying the purchasing price of the previous year by the processor notwithstanding the drop in quantities (Hingyi, 2002). A first consequence of these measures was a reduction of the dairy herd by 63 000 heads between 1991 and 1992. However it is illustrative of the chaotic situation that during the same period (1990-93), some processors were struggling on the contrary with insufficient local supply of fresh milk: Tolna Milk, the processor company of Tolna county thus offered in 1993 a non-refundable premium of 10 000 HUF to producers after each cow with calf! Briefly put, the public support system in place until 1989 entirely collapsed and left place for ad-hoc, improvised intervention policies by the state, that were in turn rapidly phased out and replaced by a laissez-faire approach: all the abovementioned intervention policies were scrapped by March 1992 (Hingyi, 2002).

Part 3. Privatizing the Dairy Sector in Hungary

The Constraint of Debt

Before looking at the strategies of public and private actors in the post-Communist restructuring of the dairy sector, it seems important to briefly mention the macroeconomic context in which privatization occurred and position the present work in the broader debate over the interpretation of post-Communist privatization.

As in many other CEE countries, Hungary's Socialist planned economy had accumulated increasing difficulties since the 1960s. After the early phase of forced collectivization and the economy's coerced Sovietization in the 1948-1956 period, the new social pact emerging in the wake of the 1956 anti-Soviet revolt under János Kádár attempted to reconcile leapfrogging industrialization with an expansion of domestic consumption and wages²³. Unlike most other Socialist states, it was perceived as vital for the regime's legitimacy and stability that industrialization wouldn't undermine living standards on the one hand, and that a collectivized agricultural sector would not undermine the cheap delivery of agricultural goods on the other (Harcza et al., 2003a). The stability of domestic purchasing power and consumption were crucial for the regime's legitimacy. However, this model proved increasingly difficult to sustain after 1956: the structural dysfunctions of the planned economy were gradually uncovered by a generation of young economists (Kornai, 1982, 1994), but these structural problems were further aggravated in the wake of the 1973 and 1979 oil shocks. Foreign debt began functioning at latest in the 1960s as a buffer mechanism for financing public investments, trade balance deficits and stabilizing consumption (Mong, 2012).

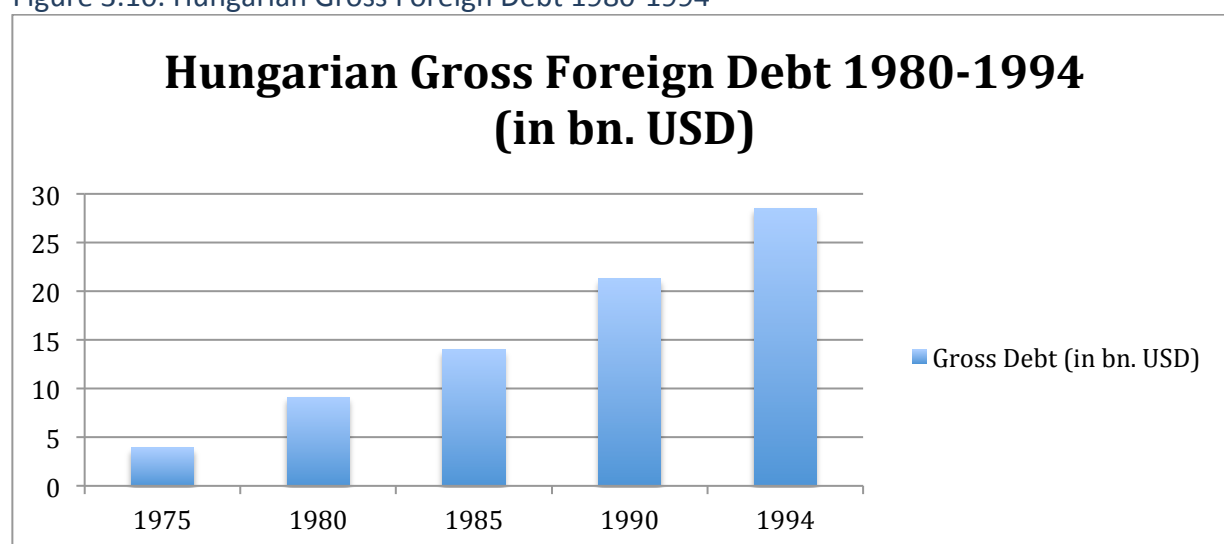
Soaring levels of foreign public debt in turn led the nomenklatura²⁴ to open accession negotiations²⁵ with the IMF and the World Bank in view of securing a safety net since

²³ In opposition to the Stalinist and Maoist experiences where industrialization occurred through the compression of domestic wages and were financed in particular through the compression of agricultural revenues.

²⁴ The position of the nomenklatura regarding Bretton Woods organizations was highly ambiguous: a young generation of economists actively lobbied in favor of integrating transnational financial markets

financing the debt service from international capital markets proved increasingly difficult (Mong, 2012). In spite of resistance from Moscow as well as hardliners in the Hungarian Central Committee, Hungary eventually joined the IMF on March 16th and the World Bank on May 6th 1982 (Honvári & Torda, 2009). Hungary received its first short term stabilization loan of 475 million special drawing rights (SDR) on December 8th 1982, complemented with a further extension of 72 million SDR on December 15th, followed by a 425 million SDR loan on January 13th 1984. Further loans were accorded on May 6th 1988 for 265 million SDR, May 14th 1990 for 159 million SDR, January 16th 1991 for 265 million SDR and a substantial three-year loan for 1, 114 billion SDR on February 12th 1991 (Csáki, 2013). However, as is evident from the below table on Hungary's steadily soaring foreign debt throughout the 1975-1994 period, new loans from the IMF and World Bank proved incapable to halt worsening public finances.

Figure 3.10. Hungarian Gross Foreign Debt 1980-1994

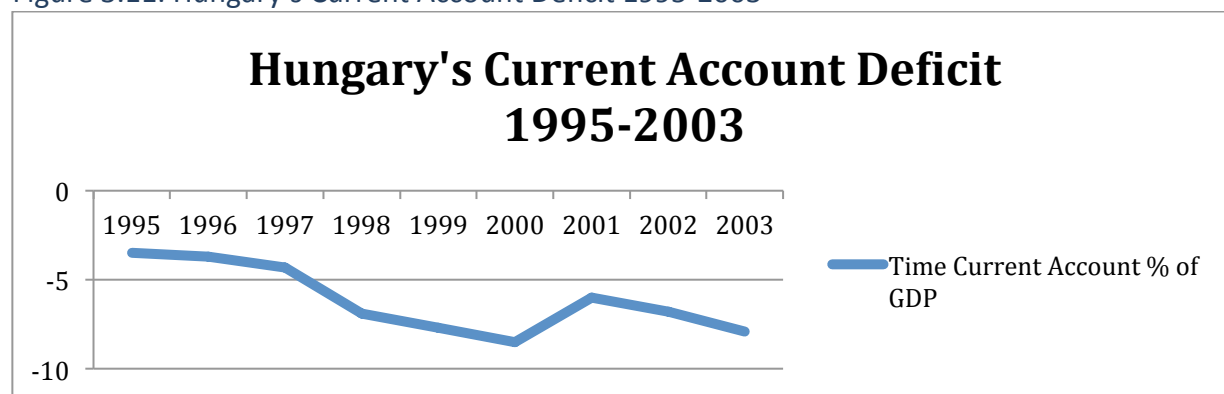


Source: (Kornai, 1995)

while „orthodox” conservatives saw it as a direct threat to the regime's autonomy, with Kádár's position oscillating between these two extremes (Mong, 2012).

²⁵ Accession negotiations actually began in the late 1960s and while membership seemed within reach by 1968, the events in Prague forced Hungary to desist under Soviet pressure. However, the Hungarian negotiation team led by János Fekete kept close personal ties with IMF leadership until the worsening conditions of 1982 made accession inevitable (Csáki, 2013).

Figure 3.11. Hungary's Current Account Deficit 1995-2003



Source: Eurostat

The debt problem was aggravated by the difficulties of the regime in building a functional domestic capital market in the 1980s. Paradoxically, the Hungarian banking system had been on the course to re-establish the functional division between the Central Bank and independent commercial banks already during the last years of the Socialist regime: commercial banks had been legally (re-) created in 1987. However, the new commercial banks inherited from the Central Bank a portfolio of companies alongside their debts, which proved overwhelming as many were on the verge of bankruptcy. In fact, public actors foresee that a new 1991 Law on accounting would actually requalify many nascent company's assets as outstanding debt – thus the state's regulatory innovations “created” a private debt problem by 1992 (Stark & Bruszt, 1998). The debt burden of commercial banks was so important that three consecutive public bailout programs were necessary until 1993 in order to consolidate the banking system. The capital crunch was twofold: the state had been short of liquidities and was only maintained afloat with the Bretton Woods stand-by loans, while the new commercial banks' already poor capitalization couldn't sustain the debt burden of their clients (conglomerates and companies such as the dairy processing plants owned by the state's Dairy Trust).

It was in this context that domestic public actors devised privatization strategies for restructuring the dairy sector. It is important to clearly spell out the competing interpretations of this process: In recent years, an emerging scholarship on Hungary's transition largely influenced by Wallerstein's World System Analysis, has put an increasingly heavy emphasis on a structuralist interpretation of privatization (Éber,

2014; Éber, Gagyí, Gerőcs, Jelinek, & Pinkasz, 2014). In this view, the transfer of ownership rights from the state to foreign investors (MNCs) was determined by the credit crunch resulting from an unbearable public debt burden on the one hand and the incapacity of the nascent commercial bank system to finance the investments that would have been necessary for the modernization of industrial conglomerates and industrial processing companies (such as the dairy processing plants) on the other. In this interpretation *integrationism* - or transnationalization through FDI and the integration of existing domestic production capacities to the supply chains of MNCs was an attempt by the state and public actors to raise foreign capital for financing the debt service. In other words, the very process of privatization was entirely determined by- and subordinate to- the debt problem in this perspective. The argument goes, that after financing domestic debt from international capital markets up to the 1980s, when private creditors' trust began to falter, Hungary first turned to the Bretton Woods organizations (the IMF and the World Bank) in the 1980s. When even these adjustment loans proved incapable to stabilize the domestic account deficit, FDI proved yet another (desperate) strategy for raising foreign capital.

We argue that the question of debt indeed played an important role in the state's privatization strategies at the onset of post-Communist transition: we equally think that the state's impetus for a fast and total privatization of the processing segment of the dairy chain in particular reflected an internal hierarchy within the state, where the concerns of the Ministry of Finance and the National Asset Management Agency (ÁVÜ, later AV and AVP Rt.) regarding the gravity of the debt problem prevailed over other considerations. When the first democratic government entered in office in May 1990, the state had foreign currency reserves of 600 million USD and a foreign debt of 21 billion USD (Kornai, 1995). However, in spite of these objective constraints, we would argue in the footsteps of Cardoso and Faletto (1979) that while history sets conditions and constraints for agency, it doesn't determine outcomes alone. We cannot explore here whether the state would have had alternative solutions in managing its debt problem. What is important from our perspective is that different public administrations represented different interests, which ultimately incapacitated the state in providing an integrated policy agenda, which would have combined the redistribution of property rights from public to private actors with a developmental agenda – as it occurred in

Poland. Managing the restructuring of different parts of the supply chain fell to different public actors, who had different rationalities: restructuring the production segment was tied to the question of land and cooperative privatization under the authority of the Ministry of Agriculture. The dairy processing segment fell however under the competence of the Ministry of Finance and ÁVU, who had one short term goal: the swift privatization of assets such as dairy processing plants, that belonged exclusively to the state. The financial question of the state budget's stability was thus entirely divorced from the problem of ensuring the long-term viability and competitiveness of agri-food sectors such as dairy. In light of the outcomes, one could conclude that the former (the Ministry of Finance and AVU) completely prevailed over the latter (the Ministry of Agriculture). The actual situation was even worse: the Independent Smallholders' Party (FKGP) which controlled the Ministry of Agriculture, in fact ended up legitimizing the dismantlement of agricultural producers' cooperatives – against its own better judgment - because of complex political games with the ruling government's majority party as discussed in the subsequent part. In a bitter irony, the part of the state, which claimed charge for defending farmers' interests thus contributed to their economic and political marginalization – while another public administration disintegrated the dairy supply chain by subtracting the processing segment from the supply chain. Briefly put, if foreign debt was as a powerful incentive structure for attracting FDI, the dairy sector's ultimate restructuring owed as much to the functional fragmentation of the state itself, which not only precluded the emergence of developmental alliances between domestic public and private actors but rendered the state itself incapable to articulate the dual problem of raising revenues in the short run, while strengthening the competitive viability of the privatized sectors.

In other words, the state's privatization agenda, which deeply restructured the dairy sector, was an outcome of particular policy preferences within distinct public administrations where the debt question was indeed used as an explanation for the necessity of selling state assets such as processing firms – however, we would refrain from arguing that it was a “mechanical” outcome of the current account deficit alone. What remains particularly important from our perspective is that in managing privatization and overseeing directly the transfer of ownership rights to foreign private

investors, the state – more precisely AVU – actively shaped FDI penetration in the dairy sector.

Land privatization: weakening cooperatives, obliterating farmers

The privatization of agricultural land stands in sharp contrast to privatization in industrial and commercial sectors (such as the processing and retail segments discussed below): foreign investors were explicitly excluded from the potential beneficiaries of land redistribution. However, while foreign ownership was excluded, the policies of the coalition government comprised of a staunchly conservative Hungarian Democratic Forum (MDF) led by Prime Minister József Antall, and its right-wing minority partner the Independent Smallholders' Party (FKGP) ultimately led to the destruction of producers' cooperatives and a fragmentation of land tenure, which not only weakened the production of raw milk by incapacitating producers' cooperatives in the dairy supply chain, but even more importantly led to the complete marginalization of farmers and the political representation of their interests. This in turn proved highly consequential as in the following decades farmers-producers would be excluded from the subsequent interest coalitions that governed the dairy sector.

A core actor in agricultural privatization was the Independent Smallholders' Party (FKGP) and its charismatic leader, József Torgyán. The FKGP was a nominal successor to a conservative agrarian party established in 1908, which had operated until 1948 when it was ultimately dissolved and banned (alongside other democratic parties) by the Communist Party. As its critics noted during the campaign of the first democratic elections in 1990, while the revived FKGP's program was notoriously vague, it had only one easily identifiable goal: "re-privatization" - which proved sufficient to win a coalition seat in the first post-Communist government alongside the conservative Hungarian Democratic Forum (MDF) and the Christian Democrats (KDNP).

The re-privatization card was successful because it could mobilize a vast electorate stretching well beyond farmers: the early optimism regarding market economy was partly motivated by the hope of retributions and compensations for expropriations

incurred during the forced nationalization and collectivization programs of the 1950s. Since the potential beneficiaries of re-privatization encompassed a heterogeneous group ranging from former aristocrats, churches and rural bourgeoisie to smallholders whose parcels, tools and machinery had been collectivized – the FKGP's re-privatization slogan thus promised material gains to a substantial part of society comprised of the self-identified losers of state Socialism when liberal parties campaigned with vague promises of democratic rights and freedoms. The FKGP's programmatic aim was the re-establishment of the pre-Communist property rights structure and the material restitution of forcibly collectivized assets. In spite of the FKGP's early electoral success and the popularity of its re-privatization agenda, the reform of agricultural property rights which was ultimately adopted not only left deep scars on the bargaining power of domestic farmers and firms in the dairy sector but on the entire agro-food complex just as it precipitated one of the most severe political crises of the post-1989 years.

The FKGP's rhetoric combined three contradictory objectives. (1) On the one hand, it proposed as early as May 1989 the so-called 1947 principle, which meant to formally re-establish the 1947 property rights structure in agriculture²⁶, that is redistributing seized assets in nature to the original owners or their progeny. (2) On the other hand, the FKGP didn't want to destroy the Socialist cooperatives nor agro-industrial conglomerates and FKGP leaders were conscious that redistribution would only be viable if it didn't lead to a fragmentation of agricultural land, which would threaten the economic viability of the sector. (3) Thirdly, the party equally sought to create a modern entrepreneurial class of rural capitalists virtually from scratch by empowering them as the targeted beneficiaries of land privatization. Quite clearly, these goals stood in tension with one another: reparatory redistribution could only happen at the expense of existing agricultural cooperatives, while returning agricultural assets to their original owners entailed the risk of creating a new class of rentiers instead of strengthening an entrepreneurial bourgeoisie²⁷. While compensation and redistribution seemed consensual, the dilemma

²⁶ The reference year was selected to be 1947 as the latest pre-collectivization date for which administrative data on land tenure was available.

²⁷ These contradictions are captured in the declarations of FKGP leaders in the 1989-1990 period. Vince Vörös, president of FKPG between June 1989 and May 1990 thus said in an interview dated June 1989: „Private property and the possibility to trade land have to be reestablished. This of course doesn't mean that well-functioning public estates and cooperatives should be dismantled. These should continue to operate but

for FKGP was to decide which social group should be empowered in the process: From this perspective, it becomes clear that “re-privatization” could either serve reparatory justice, the empowerment of specific social classes (whether the historically marginalized class of rural smallholders or the envisioned rural bourgeoisie to be created ex nihilo) or an economic modernization agenda for which the competitiveness of the domestic agricultural and agri-food sectors would have been central. However, it could not serve all of these goals at the same time (Cseszka & Schlett, 2009).

These contradictions were not apparent to the electorate until the newly formed government where FKGP controlled the Ministry of Agriculture began drafting the bill on “re-privatization”. The party was torn between two options: sticking to the “1947 principle” and effective material redistribution of public land and agricultural assets to the original owners or only offering financial compensation, necessitating a standardized system for assessing the value of expropriated land and property. A conservative faction of the party headed by József Torgyán defended the first option, while a pragmatic faction favored financial compensation. Not only was the FKGP internally split on the issue but it became apparent already in the course of 1990 that the coalition’s majority party, the MDF - chief of which Prime Minister József Antall – was fundamentally opposed to redistribution in nature: Antall and the MDF considered that a wide-scale redistribution of land would destroy the competitiveness of agriculture and agri-food sectors. Antall convinced the FKGP (Torgyán included), that in exchange for their support on a bill regarding the privatization of catering establishments through auctions, the MDF would be willing to accept a limited re-distribution of agricultural land and property in nature: FKGP accepted the deal. What the FKGP leadership failed to understand was that selling catering establishments through auctions – in disregard of the original owners – created a precedent for the Constitutional Court: It was impossible for the Court to acknowledge the primacy of original ownership in a sector and ignore it in another. In other words, Torgyán only understood after the fact that the seemingly subsidiary question of catering establishments’ privatization legally foreclosed the possibility for material compensation in agricultural land. After securing the FKGP’s support for auctioning restaurants, Antall sent two questions to the Constitutional Court

the ownership of land has to return to the peasant. We don’t want a new distribution of land, which would lead to a disaster.” (quoted in Cseszka & Schlett, 2009).

for a preliminary constitutionality review, enquiring over the legality of material compensation regarding agricultural land and property: as expected, the Court made clear (1) that no discrimination was acceptable between the compensation mechanisms of different sectors, and (2) that the land and property of agricultural cooperatives could not be expropriated for compensating their original owners. Torgyán's clique felt betrayed: on the one hand, they had to face the opposition of the National Council of Agricultural Cooperatives (MOSZ) to the "1947 principle", while Antall, the MDF and the Constitutional Court barred any further route to material compensation²⁸ (Cseszka & Schlett, 2009).

As a result of these complex political games, the option of financial compensation was eventually adopted by the pragmatic faction of the FKGP under increasingly strong pressures from the MDF: the law was finally adopted on April 24th 1991. The selected method was privatization through public auctions with vouchers: the value of expropriated land was fixed in "golden crowns", a measure integrating not only the size of seized land and assets but also their agricultural productivity. The claimants were entitled to vouchers denominated in golden crowns (guaranteed by the state) in relation to the value of their expropriated property. These vouchers could in turn be used for purchasing agricultural land at public auctions.

It should be noted that ironically, while the Constitutional Court had previously deemed the material redistribution of cooperative assets unconstitutional, the financial compensation mechanism nonetheless forced cooperatives to sell a substantial part of the land they controlled: cooperatives had an obligation to divide their land in four categories: land in collective ownership and collective use, cooperative land in state ownership, land in collective ownership but privately used and land in "mixed" ownership between the cooperative and its private owners²⁹. The stock of land to be

²⁸ The tension between the two men became so severe that Torgyán began to publically call for Antall's resignation, while Antal leaked confidential documents allegedly proving Torgyán's cooperation with the Communist secret services during and in the aftermath of the 1956 revolution. The FKGP was not only ideologically divided but formally split in two when Torgyán's faction and those loyal to the coalition government mutually expelled one another from the party.

²⁹ The questions of "fuzzy", or „recombinant" property, the integration of state farms, cooperatives and private property, as well as the increasing importance of a grey economy in the 1980s were of central

auctioned derived for one part from cooperative property, while the other was provided by the state: after dividing their land in the abovementioned four categories, agricultural cooperatives had to isolate within the category of “collective ownership and use” a portion destined for sale. On the other hand, the state contributed with 20% of its own land estates to the land fund³⁰. A provision of the law further stipulated that if individual members of agricultural cooperatives didn’t dispose of vouchers (that is, if they were not legal claimants or heirs to seized land), they nonetheless were entitled to 30 golden crowns worth of land for cooperative members and 20 golden crowns for employees thereof³¹. Another provision fixed a cap for the transactions at a maximum of 300 hectares or 600 golden crowns for natural persons: this was an attempt (albeit largely inefficient) to avoid speculation and the emergence of vast personal estates³². Finally, only the members of agricultural cooperatives, the original owners or natural persons residing in the same locality could bid for cooperative land: other claimants could only bid for state-owned non-cooperative land³³. The MDF’s preferred option of financial compensation (instead of direct material redistribution) had been motivated by the fear of incapacitating agro-industries with an unviable property rights structure: However, the effects of what was thought to be a limited compensation mechanism proved sufficient to radically modify the existing property rights regime and create precisely the type of dual market both the MDF and the FKGP originally sought to avoid. Table 3.9 shows the breakdown of these transactions:

interest to the students of late-Socialist and post-Socialist property rights (Harcza et al., 2003a; Stark, 1996; Verdery, 2004).

³⁰ It should be noted here that the category of „land” was broader than agriculturally productive assets: forests were included just as arable plough land. The rationale was that the common metric in „golden crowns” as an integrated measure of size and productivity would assign a different market value to productive and unproductive estates.

³¹ The aim was to reduce potential tensions between cooperative members and the new buyers by offering a „safety net” of compensations for the cooperative workforce.

³² However, the law only concerned the maximum amount that could be purchased under the privatization scheme: where legal persons already disposed of estates in excess of 300 hectares and/or a value superior to 600 golden crowns, they were not obliged to sell the exceeding part of their property. This also proved a weakness for the purported egalitarian goal of privatization, since the early, unregulated phase of „spontaneous privatization” that had preceded 1989 had already created larger estates.

³³ Since the land of agricultural cooperatives was of higher value (as it was arable plough land, unlike much of the poorly used land offered by the state), the above restriction meant that cooperative members generally received the most expensive and higher quality plots.

Table 3.9. Privatization of Agricultural Land in Hungary

	Land from Cooperatives	Land from State	Total
Area (ha.)	1 975 458	165 987	2 141 445
Distribution (%)	92,3	7,7	100
Value in Golden Crowns	37 496 169	1 759 767	39 255 936
Average area size (ha.)	2,3	0,8	2
Average Value in Golden Crowns	44	8,5	37
Number of Beneficiaries	612 010	147 777	759 787
Total Number of Transactions	21 345	5 412	26 757

Source: (Dorgai, 2004)

This table summarizes a number of defining weaknesses in the process: First, the imbalance between cooperative (92,3%) and state-owned land (7,7%) shows that in spite of its alleged goal as a retribution mechanism that wasn't meant to cripple cooperatives, the compensation or re-privatization process overwhelmingly concerned cooperative land. Second, while the process was meant to be restricted in scope, it actually concerned close to 2 million hectares, that is a third of Hungary's total agricultural land. Third, the vast majority of transactions concerned small plots ranging from one to two hectares, which resulted in the dreaded fragmentation of land that policy makers explicitly wanted to avoid. Finally, claimants could seldom acquire larger contiguous plots, which meant that the new landowners ended up with small plots of land scattered throughout the country. The consequences of geographic dispersion were just as negative as fragmentation: the two phenomena created a situation where a majority of smallholders couldn't profitably use these plots for agricultural and agro-industrial activities, while the remaining cooperatives who could have used them were forced to rent land from a plurality of new owners (often their own membership) through leasing contracts, most of which were soon terminated by one of the contracting parties³⁴.

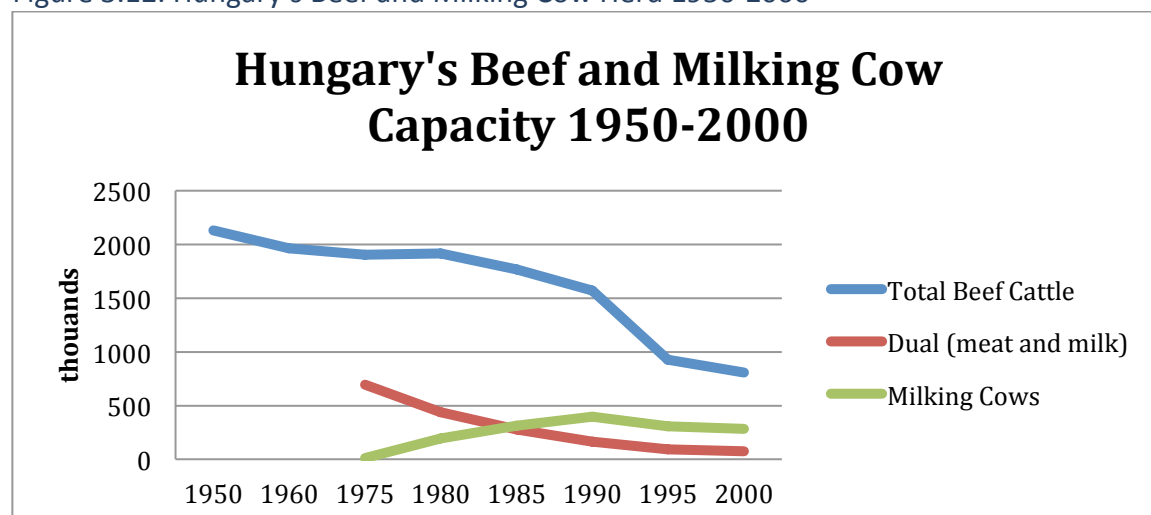
The 1991 law on the "re-privatization" of land had three fundamental consequences for the dairy sector: (1) As cooperatives were eventually forced to sell off their land for "compensating" original owners, it led to the rapid marginalization of dairy producers'

³⁴ The Hungarian Institute for Agricultural Research (AKI) conducted a study in 1998 to examine the durability of contractual relations in leasing contracts that resulted from the new property structure. The study found that 80% of the contracts had been terminated by one of the contracting parties (Herbst, 2000).

cooperatives which had played a substantial role not only in the production of fresh milk but also as joint owners of processing plants (see previous section on the institutional structure of the dairy sector under Socialism), (2) The small size and geographic dispersion of land plots ensured that the new private owners of redistributed land would be economically unviable: farmer-producers who benefited from the re-privatization of (mostly) cooperative land were anything but empowered by their newly secured private property. On the contrary they formed the bulk of agricultural workforce (notably smallholder cattle breeders) who were gradually forced out of the market throughout the 1990s as they couldn't secure the necessary capital for investing in technological upgrading (Gorton & Guba, 2002). (3) The active role of the Smallholders' Party in the erratic and self-defeating privatization of land greatly participated in the party's loss of legitimacy. They managed to secure a second minority coalition partner status in the first Orban government of 1998 but they were entirely marginalized from party politics in later elections. Thus, not only did the only large political party representing farmers' interest lose the support of the very class it allegedly sought to represent, but the re-privatization it left as a legacy ensured a fragmentation of property rights among producers that left them atomized, without viable assets, without institutional structures guaranteeing access to capital and productive assets to a "large cross-section" of farmers, namely cooperatives– and without any political representation. The marginalization of farmers in the dairy sector throughout the 1990s accelerated as producer cooperatives were disbanded: by 1997, farmer cooperatives only represented 3% (697 million HUF) in the capitalization of the overall dairy sector, which stood at 23,4 billion HU (M. Szabó, 1999).

Ultimately, the unfavorable fragmentation of the new property right regime stripped farmers from the mobilizational capacity that would have been necessary for participating in the re-regulation of agri-food sectors such as dairy. The long-term exclusion of farmers from the defining coalitions that shaped the sector's transformation throughout the 1990s and 2000s can be traced back to the mismanagement of land privatization. This, in combination with the overproduction crisis that resulted from scraping consumer price subsidies for dairy products and the incentives for a reduction of production capacities that we discussed earlier, has led to a drop in the cattle herd size in the immediate aftermath of the regime change, as illustrated in Figure 3.12

Figure 3.12. Hungary's Beef and Milking Cow Herd 1950-2000



Source: Hungarian National Statistical Office (KSH)

Privatizing Processors to MNCs

Contrary to the privatization of the production segment (tied with the re-privatization of land and cooperatives), the privatization of dairy processing followed a different logic: the state owned directly the vast majority of dairy processing plants managed by the Dairy Trust, while the gradual marginalization of producer cooperatives also ensured that in those plants where cooperatives had been joint owners, their participation was rapidly reduced. By 1997, cooperatives only controlled 2,4% of processing (M. Szabó, 1999). A specificity of the Hungarian politics of privatization was that while the question of cooperative-, and most importantly land- privatization became highly publicized, politicized and contested issue areas, the privatization of other agricultural assets, notably processing companies, received substantially less attention (Harcza et al., 2003b). Neither farmers, nor the Smallholders' Party had formulated coherent strategies or policy preferences in relation to the privatization of processing plants, which left the state free to manage the sector's assets as it saw fit. It was in this particular context that the Dairy Trust was disbanded on March 1st 1991, while the 15 dairy processing companies that had functioned as the central nodes of the separate and regionally independent dairy supply chains – were transferred to the state's newly created privatization agency.

Each of these regional processing companies had been composed of a network of processing plants: the first step to privatization entailed breaking up the 15 companies into 36 new, independent dairy processors (Gorton & Guba, 2002). The second stage was their sale through the privatization agency to new investors. Contrary to land privatization where sale to foreign physical and moral persons was legally banned, MNCs played the leading role in buying these processing plants. The first MNCs to enter the processing sector through brownfield investments purchasing from the pool of 26 individual processing plants were Italian Parmalat and Irish Avonmore in 1992. These firms paved the way for an accelerating process of MNC expansion in dairy processing: Bongrain, Nutricia, Danone, ERU were quick to follow. By 1996, MNCs controlled 60% of processing, at the end of the decade, this figure reached 85% (Szajner & Vőneki, 2014a), however, in the mid 2000s, these very MNCs began leaving the Hungarian sector one after another leading to a re-domestication of the market. In the following, we will review the strategies of some of the most illustrative firms in order to understand why the prevalence of MNCs didn't lead to economic upgrading and how domestic firms and the state reacted to MNC strategies.

Parmalat

In 1992, Parmalat purchased the second biggest Hungarian dairy - the Fejér and Komárom Counties Dairy Company - located 60 kilometers West of Budapest in Székesfehérvár. Parmalat was pioneering in the implementation of new management techniques: it established its own transport and distribution network throughout the country, set up 8 depot centers and equipped its collecting cooling trucks with computers that could monitor orders in real time (M. Szabó, 1996). In spite of increasing complaints from suppliers that Parmalat systematically delayed payments, the company grew steadily throughout the 1990s and by 2002, it controlled 8% of the domestic market, with a specialization in fresh milk and fruit yoghurts (Tímár, 2004). However, a scandal revealed in 2003 that Parmalat Hungary's parent company, the Parmalat group controlled by the Tanzi family, had used the services of Bank of America's Italian chief of corporate finances to forge the publically traded company's accounting: the investigations revealed that Parmalat had kept a lid on 14,3 billion USD debt (Chalkidou, 2011). When the investigations began in Italy, it became evident that Parmalat Hungary had equally followed questionable business practices. Parmalat Hungary's management

failed to communicate to its Italian parent company the debts it had accumulated: By 2003, it owed 720 million HUF to its suppliers³⁵. When it became clear that the financial situation of the company was untenable, the management had to face the pressure of its suppliers, its employees and the National Milk Council (the only regulatory body at the sector level), which had lent 500 million HUF to Parmalat. The Head of Parmalat's union of employees, Ms. Bocs, sided with the suppliers as she argued that the management purposely delayed payments until it could apply for bankruptcy protection, which would threaten 450 local jobs. As suppliers and employees understood it, if they let Parmalat Hungary benefit from bankruptcy status, the company would be legally protected in withholding payments to suppliers, and potentially wages too (Bihari, 2004). The management offered to convert the outstanding debt to its suppliers into company shares, an option refused by the suppliers. Parmalat's suppliers filed for a liquidation procedure against the firm, while the management requested bankruptcy protection³⁶: the tribunal sided with the suppliers and Parmalat was forced to resume its delayed payments (Kitta, 2004). The difficult settlement negotiations aside, Parmalat's main goal was to terminate its operations and leave the Hungarian market: Eventually, the Székesfehérvár plant was bought by the only domestically owned heavyweight dairy cooperative, Alföldi Milk in 2005: although Alföldi Milk didn't have sufficient liquidities, the cooperative benefitted from a preferential loan by the Hungarian Development Bank³⁷ to purchase the plant (Voszka, 2009).

Avonmore

Just as Parmalat, Avonmore³⁸ entered the market in 1992: by then the Central Hungarian Dairy Company (KTV), one of the original 15 Socialist dairy firms, was on the

³⁵ The debt was a consequence of delayed payments to farmers, which are a typical consequence of the types of contracts between MNC processors and small producers, where MNCs exonerate themselves from paying on delivery.

³⁶ The difference between the two procedures is the primacy afforded to the company or its creditors: liquidation prioritizes the claims of creditors, while bankruptcy protection protects the company's capital in spite of outstanding debt.

³⁷ Although this type of support for stabilizing food processing companies on the verge of bankruptcy was a relative novelty in 2005, this form of intervention later spread to other agri-food sectors in the wake of the financial crisis. (Voszka, 2009).

³⁸ Note: Avonmore has since changed its name to Glanbia.

verge of bankruptcy. Instead of buying the entire company, Avonmore only bought one of KTV's processing plants in Pásztó (80 km North East of Budapest) (M. Szabó, 1996). The specificity of Avonmore compared with other MNCs is that it is a cooperative of Irish farmers, which operates as an MNC abroad: a recent research on the behavior of Avonmore and similar transnational dairy cooperatives showed that while these firms have a strong cooperative identity in their home countries, they operate as classical MNCs in their external operations (Bijman, Pykkönen, & Petri, 2012). This insight was confirmed in the Hungarian market, where Avonmore adopted an aggressive expansionist strategy selling below procurement prices: the rationale for the firm was to quickly capture a substantial share of the domestic market in order to realize economies of scale. However, the investment in Pásztó soon turned against Avonmore: the firm was specialized in high quality fresh milk, which needed a steady supply of premium quality raw milk. Pásztó on the other hand is a small village of 10 000 inhabitants, with average transport infrastructure, geographically isolated from the traditional cattle breeding regions of the Southern and Western plains. The poor choice of location coupled with the structural problems of land fragmentation and poorly regulated leasing contracts (resulting from the 1991 privatization law) made Avonmore's aggressive pricing strategy increasingly unviable. The firm operated with a loss in excess of 2 billion HUF (Tímár, 2004). By 1997, the home company was confronted with the choice of either selling the Pásztó plant to competitors or raising new capital: the management began negotiations with two venture capital firms, Euroventures and Equinox, which invested 2 million euros³⁹. The investment funds secured two seats out of three in the new Board, and alongside the capital they injected, they encouraged the management to introduce a new product on the market: a type of sour cream in which milk fat was replaced with vegetable oil. The investment proved successful from a financial perspective: sales doubled to 45 million euros. This was precisely the moment that Avonmore chose to leave the Hungarian market and sell the Pásztó plant to Sole, a competitor owned by Italian investor Gala Italia. It is telling that the operation still figures on the Hungarian Private Equity and Venture Capital Association's website under the "success stories" heading although Sole actually closed down the Pásztó plant in 2004, the 300 local

³⁹ Source: <http://www.hvca.hu/pevc-explained/private-equity/pe-success-stories/avonmore-p%C3%A1szt%C3%B3-by-euroventures-and-equinox/> accessed 17/04/2014

employees were fired and the technically well-equipped plant which had processed 200 million tons of milk yearly has been left to rot⁴⁰.

Danone

French Danone is another major MNC that entered the Hungarian market in the first half of the 1990s. The trajectory of the company's operation in Hungary in many ways reflects the experience of Parmalat and Avonmore. The Budapest Dairy Company (BTV) was one of the Socialist dairy companies created in 1964 through the merger of pre-war Budapest dairy processing plants. At the onset of privatization and market liberalization, BTV first entered a licensing deal with Danone in 1991: BTV produced and marketed Danone yoghurts for the domestic market. The second step was the creation of a joint stock company between Danone and BTV, which was ultimately disbanded when Danone bought out BTV's share and the Budapest processing plant became Danone's sole property in 1994 (M. Szabó, 1996). In 1995, Danone made a lesser investment by buying a small processing plant in Marcali (Western Hungary, south of lake Balaton), where it produced "Túró Rudi", a specifically Hungarian chocolate and cheese bar. In Budapest, Danone reduced the plant's product portfolio, stopped producing fresh milk and flavored milk products to focus entirely on higher value added products such as yoghurts, desserts, sour cream and kefir. Danone's Hungarian operation was coordinated with a larger Central European investment plan as the firm invested simultaneously in Poland, the Czech Republic, Romania, Bulgaria and even Ukraine in the first half of the 1990s. In a first period, Danone favored national specialization: fruit yoghurts were imported from the Czech Republic while puddings were exported from Hungary to other CEE markets, however after 1995, the products destined to the Hungarian market were all produced at the Budapest plant. By 2004, Danone controlled 63% of the yoghurt market and 37% of desserts (Tímár, 2004). The firm invested massively in upgrading technology and enforcing up to date food safety standards: between 1991 and 2001, it invested more than 10 billion HUF in the Budapest plant's modernization. The registered capital grew from 10 million HUF in 1991 to 2,5 billion by 1996. The last major investment occurred in 2003 when Danone bought state of the

⁴⁰ Source: www.palyazat.gov.hu/download/933/Pasztó.doc accessed 17/04/2014

art machinery for producing desserts for 600 million HUF. In 2001, Danone's revenues amounted to 20 billion HUF and the net profit exceeded 1 billion HUF (Neuberger, 2014). The early 2000s marked the zenith in Danone's expansion: the company attempted to diversify beyond dairy, notably in the biscuit market and purchased the Győr Biscuit Company (Győri Keksz) in 2000 from United Biscuits. Throughout the 2000s however, the firm gradually retreated from the market. A major PR problem occurred in 2001, when internal plans to close the Győr biscuit plant leaked and mobilized an online petition and consumer boycott movement to defend local jobs and the survival of the plant: under the pressure of public opinion and the Hungarian government, Danone chose to keep the plant but fired 300 employees. Danone's public image was deeply stained in the process⁴¹. In 2009, Danone sold the Marcali plant to Sole-Mizo but the erosion in competitiveness accelerated after 2010: profits decreased from 1, 2 billion HUF in 2010 to merely 82 million in 2012⁴². In 2013, Danone unveiled a new regional reorganization of its CEE activities with Budapest as the new managerial and distribution hub for the region. Yet in June 2014, Danone announced the liquidation of the Budapest plant scheduled for 2015, terminating all processing activities in Hungary: Danone products would be sourced from Poland and Romania in the future. At present it remains uncertain whether the Budapest plant will be sold or simply shut down.

Nutricia/Friesland Campina

The restructuring process caused by Dutch MNC Nutricia is another paradigmatic example of MNCs' role in the Hungarian dairy sector. Numico Internationale B.V. is a Dutch firm founded in 1901 specialized in baby food. The Nutricia Dairy and Drinks Group was a division of Numico until 1997 when it became an autonomous company.

⁴¹ The anonymously written online petition resurfaced periodically on the Hungarian web in 2003, 2005, 2007 and it allegedly led to a 10% loss in Danone's sales. Eventually, Danone sold the Győr biscuit plant to Kraft Foods in 2007, which has kept the plant in operation since. In spite of this, for the public opinion Danone came to exemplify the archetypal predatory MNC that seeks to buy and close any competitor to its market share in Hungary.

Source: http://tudatosvasarlo.hu/attachment/file/36/Tudatos_vasarlok_bojkott_kezikonyve.pdf accessed 01/07/2015

⁴² However, this decrease in revenues and profitability probably wasn't only an outcome of decreasing demand and/or the financial crisis as it was also preceded by a steady reduction of Danone's registered capital in Hungary, which had decreased from a 1996 maximum of 2,5 billion to 1 billion by 2004.

Nutricia entered the Hungarian market through the pharmaceutical sector: in 1993, it established a joint-stock company with the century-old Hungarian pharmaceutical company Egis: Egis-Nutricia Kft. The new company marketed Nutricia's baby food and nutrition complements in Hungary. In 1995, Nutricia ventured in the dairy sector by purchasing 22,5% of Hajdú Milk, a dairy plant located in Debrecen (close to the Romanian border in the South-East) and owned by the National Privatization Agency since 1993. By 1996, Nutricia increased the capitalization to 96,7% and replaced the Hungarian management with Dutch personnel. In the following years, Nutricia's used Hajdú Milk as a Trojan horse in the dairy sector in order to purchase a number of smaller processing plants, which were gradually integrated to Hajdú Milk's infrastructure: Hajdú purchased Sárrét Milk and Zalka Milk in 1997, followed by Balmaz Milk in 1998, Szabolcs Milk in 1999 and finally Mátra Milk and Gyöngy Milk in 2000 (GVH, 2000) ⁴³. Nutricia invested heavily in the technological upgrading of the new facilities it acquired: in 1998, it didn't pay dividends to shareholders and reinvested 276 million HUF (Pecze & Soczó, 2002). By 2000, the Nutricia group owned 26% of Hungarian dairy processing. Nominal changes in ownership occurred when Nutricia Hungary's parent company, the Nutricia Group was purchased by Dutch dairy cooperative Friesland in 2001 and later when Friesland in turn merged with Dutch dairy Campina in 2007 (the new FrieslandCampina group is the biggest dairy MNC with a cooperative structure and the fifth biggest global dairy processor) - yet these mergers didn't affect the group's Hungarian operations ⁴⁴. The negative impact of Nutricia/FrieslandCampina's extremely rapid merger and acquisition strategy only materialized over time: The newly purchased facilities were systematically scaled down and only those operations were kept, which could compliment Hajdú Milk's original infrastructure. However, this form of production rationalization went beyond mere restructuring: Nutricia closed down the smaller processing units one after the other. Between 2004 and 2007, Nutricia closed down six processing plants and fired a

⁴³ Although the National Competition Agency authorized these mergers, it is also clear that the rapid growth of the Nutricia-Hajdú Milk group was preoccupying. The Competition Agency's Vj-159/2000/16 resolution, which authorized the purchase of Mátra Milk and Gyöngy Milk, argued somewhat unconvincingly that due to the group's geographic concentration in the South East, Nutricia didn't pose a threat to free competition at the national level since they "only" controlled 40% of the South Eastern regional market.

⁴⁴ The Nutricia-Friesland merger was only problematic in Hungary because Friesland had independently invested in another Hungarian dairy brand, Mizo: the Competition Authority only prevented the Friesland group from increasing its capitalization in Mizo above 33% (GVH, 2000).

thousand employees. In the 1998-2004 period, Nutricia first rationalized the production structure by specializing each processing plant in a particular product (prior to the takeovers, these units had a similar profile and produced a variety of products): Hajdú Milk as the flagship plant was specialized in more complex and higher value added cottage cheese, sour cream and yoghurts, while the rest of the plants produced milk powder and fresh milk. In the second, 2004-2007 period, Nutricia nonetheless closed all smaller units with the exception of the Debrecen Hajdú plant and the “Dotted” (*Pöttyös*) brand of cottage cheese filled chocolate bars in Mátészalka (Easternmost Hungary). The rationale for this strategy was a repositioning of the product portfolio towards the higher value added product range, especially since the 2004 EU accession threatened to flood the domestic market with cheap fresh milk products from foreign competitors. Nutricia/FrieslandCampina consistently argued that closing down the processing plants it had recently acquired became necessary because production capacities were structurally underutilized⁴⁵: an argument that is difficult to accept since underutilization was a direct consequence of the management’s strategy in reducing the product portfolio. This trend in downscaling culminated in 2015, when FrieslandCampina announced that it would sell the flagship Debrecen plant to domestically owned dairy cooperative Alföldi Milk (which had previously purchased Parmalat’s processing plant in 2005 after the Italian firm went bankrupt).

Bongrain

Another notable MNC in dairy processing is French Bongrain, a family company that began its expansion outside of France in CEE during the 1990s. Bongrain offered thrice the reference price for purchasing Veszprém Milk (Western Hungary) in 1994, after which it also bought the Répcelak Cheese Company in 1995 (North West Hungary) and Zala Milk in 1997: the latter two were united in the new Pannon Milk company while Bongrain operated Veszprém Milk independently in parallel. Bongrain is entirely specialized in cheese and the firm seems to follow a similar pattern to other MNCs in dairy processing, that is a gradual exit from the Hungarian market, although the shift is less spectacular: while its revenues rebounded in the wake of the crisis from 12 to 18 billion HUF between 2010 and 2013, the net balance after taxes worsened from -41

⁴⁵ Source: http://mno.hu/migr_1834/elbocsatasok-utan-koncentracio-423627 accessed 30/04/2014

million to -555 million HUF over the same period⁴⁶. Market analysts also noted that Bongrain relocated the production of some Hungarian cheese brands destined to the domestic market to Poland and the Czech Republic, thus worsening the domestic trade balance⁴⁷. According to the Hungarian Milk Council's estimates, the combined share of Bongrain, Danone and FrieslandCampina's purchase of milk from Hungarian producers only amounted to 10% of total volumes in 2013 (Terméktanács, 2013).

Strategies of Hungarian Processors

Domestically owned processing firms offer a symmetrical mirror image to MNCs: while the 1990s marked their complete marginalization, the unexpected re-domestication of the market began gradually in the early 2000s, just as MNCs started leaving Hungary. Two firms stand out in particular: the Alföldi Milk producer-processing cooperative and the SoleMizo group.

Alföldi Tej

Alföldi Milk has a peculiar position in Hungarian agri-food: it is the only commercially successful large-scale producers' cooperative that emerged since 1989. The cooperative model still faces a severe legitimacy crisis in Hungary: On the one hand, privatization in the 1990s contributed to undermining the cooperative form of production. On the other hand, the very property rights structure resulting from privatization left domestic producers and processors extremely weak in the face of competition from MNCs. In this landscape, Alföldi Milk is the first successful example at re-instituting collective organization among domestic producers: albeit its members are mostly big farms with strong capitalization⁴⁸. The cooperative was set up by 54 members in 2003 in the vicinity of Debrecen where Nutricia/FrieslandCampina operated. In a first phase, the cooperative supplied the Friesland processing plant as well as Sole, an Italian-owned

⁴⁶ Source: <http://www.vg.hu/vallalati-adatok/pannontej-zrt> accessed 19/04/2014

⁴⁷ Source: <http://www.tejtermek.hu/attachments/article/394/Sajt%C3%B3szemle%202014%20j%C3%B1us.pdf> accessed 06/07/2014

⁴⁸ Interview with Tibor Mélykuti, 01/12/2013

processor in Győr (Southern Hungary). Alföldi Milk benefitted from Parmalat's bankruptcy in 2003: the Italian management sought to sell the processing plant in Székesfehérvár, which matched with Alföldi's strategy of autonomization from processors Sole and Friesland. The acquisition of a processing plant had been one of the original objectives for Alföldi Milk. Eventually, the 1,8 billion HUF purchasing price for the processing plant allowed Parmalat to compensate its suppliers and creditors during the liquidation procedure, while it secured Alföldi's autonomy as an integrated producers' processor group. The operation was supported by the state and financed with a 4 billion HUF loan from the Hungarian Development Bank (Gazdaság-MFB, 2009). Alföldi not only inherited the processing plant but also Parmalat Hungary's Italian export market: unlike MNCs that primarily sought to produce for the domestic market, Alföldi became a prime exporter of Hungarian dairy products, although essentially whey and milk powder to Italy (that is low value added products). This is notable because Italy became the primary export destination for Hungarian dairy products at the entire sector level. Alföldi's cooperative structure means that unlike all its competitors, whether smaller domestically owned processors or larger MNCs such as Danone, Friesland or Bongrain, production and processing are firmly integrated, which stabilizes the supply chain. Alföldi's 2015 investment in Debrecen symbolically crowned the management's successful strategy: when FrieslandCampina (former Nutricia) sought to disinvest and sell even its flagship plant in Debrecen (formerly Hajdú Milk), Alföldi could rely on its previous experience in buying out Parmalat's plant in 2005. In the framework of GVC theory, Alföldi Milk is a prime example of *functional upgrading*, as the firm climbed up the value chain by turning from a supplier into a sizeable processor (Humphrey & Memedovic, 2006).

Baranyatej/Mizo/Sole

Alongside Alföldi Milk, the second important domestically owned group is Sole-Mizo, controlled by János Csányi⁴⁹, one of the most prominent Hungarian tycoons. Contrary to

⁴⁹ Csányi is notably the CEO of Hungarian bank OTP, also present in sports (he is heading the Hungarian Football Association). The agricultural part of his empire is called the Bonafarm Group, regrouping a dozen processing firms in meat (Pick), cereals (Bábolna), wine (Csanyi) and dairy (Sole-Mizo).

Alföldi Milk, Sole-Mizo is not a cooperative but a purely private company. The group was born from the merger of two firms (Sole and Mizo).

Mizo was the heir of Baranya Milk, a processor based in Pécs (South of Hungary), privatized in 1993 by the National Privatization Agency. The ownership structure of the new company was unclear but many suspect that Dutch bank ABN Ambro held an indirect majority stake through a Hungarian proxy⁵⁰. An important change occurred in 1997 when two Hungarian investors (Miklos Jederan and Zoltán Bajczi) purchased a majority share in Baranyatej, and oversaw the firm's expansion, mirroring the strategy of MNCs: in December 1998, Baranyatej acquired smaller processors Győr Milk, Class Milk and Bács Milk and re-branded the group as "Mizo". However, Mizo accumulated a deficit of 900 million HUF in 1998 and stopped paying its suppliers (due to the commonality of delayed payments in the dairy sector, the cessation of payments meant that Mizo effectively refused to pay farmers retroactively for milk it had already utilized) after the processor's creditor banks stopped financing it. The two owners blamed the banks (Raiffeisen and the Hungarian Commercial and Credit Bank), while farmers set up an ad-hoc "consortium" (the Consortium of Milk Producers of Baranya County) in order to reclaim Mizo's outstanding debt. The motivations behind the banks' sudden refusal to continue financing Mizo are controversial: although the owners had effectively indebted the company through major loans in 1998 (by 1999, Mizo had a debt over 6 billion HUF), Mizo's commercial operation was nonetheless profitable by 1999. However, short of capital, Mizo couldn't finance its daily costs nor repay its suppliers. When the public outrage among dairy suppliers eventually forced public authorities to intervene, the state's reaction was equally peculiar: instead of extending an emergency credit line to Mizo, or alternatively to offer the same credit to the Consortium of suppliers for them to purchase the processing plant and thus become actual owners of the company (the two options seemed realistic at the time and the latter effectively occurred when the state offered a preferential loan to Parmalat's suppliers in order to purchase a processing plant in 2005 as mentioned above), the Ministry of Agriculture instead chose to liquidate Mizo and only offer a preferential loan to the suppliers worth 500 million HUF - not for purchasing Mizo but merely as compensation. After the bankruptcy procedure, Mizo's

⁵⁰ Source: http://fn.hir24.hu/gazdasag/1997/02/12/tejipar_privatiz_ci_ut/ accessed 05/05/2014

assets were bought by agricultural joint-stock company Almand Ltd. in 2002 (itself controversially privatized in 2001 under the first Orban government)⁵¹ and re-branded as “New Mizo” (Új Mizo). Eventually, Csányi acquired Almand Ltd. in 2003, and through Almand, New Mizo as well in 2003, which raises the suspicion that Mizo’s financial ordeal might not have been entirely independent from Csányi’s long-term objective of building an agricultural empire in the early 2000s.

Sole’s trajectory is similar to Mizo: The Regional Dairy Processor of Csongrád County, established in 1955, first transformed into a private company in 1991. Under this restructuring, only three processing plants were kept from the regional processing structure, chief of which a plant in Szeged (South East). The company was privatized in 1997 to Sicilian company Gala Italia, the monopolistic processor of Sicilian dairy since the 1960s. Gala Italia first entered the Hungarian market in 1997 and acquired a majority share in Szombathely Dairy Ltd.: The latter was a secondary processor, which belonged to the workers and the management since its 1993 privatization. In 1999, Gala Italia went further and purchased the Pásztó plant left behind by Avonmore as described previously (later closing down the plant in 2004). Finally, in 2000, Gala reorganized its three Hungarian operations around the central plant in Szeged (South East) and re-labeled its brand to Sole Hungaria. However, Sole’s operation in Hungary was compromised as a result of external and local factors: Sole had equally entered the Slovak market in 2001 and acquired a majority share in four processors but the operations of the Slovak subsidiary (Sole Slovakia) turned to a loss by 2003 and the Italian parent company sought to deleverage its foreign operations. As a result, Sole left both Slovakia and Hungary in 2003 and 2005 respectively. The Italian owners explained that the reduction of the subsidy on feta cheese in 2004 also played an important part in their decision to leave the Hungarian market. Ultimately, Csányi bought Sole Hungaria in 2006 and integrated it to his multi-sectoral agri-food empire Bonafarm by creating the Sole-Mizo brand. After the merger, Sole-Mizo instantly became the biggest processor in Hungary, with a 31.7% market share and relegated FrieslandCampina to the third place behind Alföldi Milk. The latter controlled 20% of the market in 2013: in other words, the

⁵¹ Dalmand Zrt. Later figured prominently in the press as one of the „Green Landlords” – a group of agricultural and agrifood firms suspected of forming a clientele to the Conservative Fidesz Party headed by Viktor Orban.

two big Hungarian dairy processors represent today half of the market together, which is a fundamental change compared to the 1990s. We call this process the re-domestication of the dairy sector.

Privatizing Retail

The trajectory of retail far overstretches the confines of the present thesis as it comprises a sector of its own, yet food processing such as dairy is integrated to the supply chains of food retailers. We cannot offer here an extensive overview of the retail sector's complex re-organization, therefore we would only concentrate on the key aspects that affected the dairy sector. We would single out three aspects in particular, which had a direct consequence on dairy: (1) The privatization of retail not only transformed ownership structures but strengthened new marketing formats previously inexistent on the market. MNCs played the leading role in the diffusion of super- and hypermarket formats. (2) Contrary to other sectors, such as food processing, domestic firms proved more resilient from the onset of retail privatization, (3) In light of their buying power in the food supply chain, retailers were increasingly pointed out as the prime enemies of domestic producers in the 2000s: however instead of farmers, it was the domestically owned fringe of dairy processors that initiated a lobbying effort against (foreign) retailers. This strategy led to the consolidation of an alliance between domestic dairy processors, the state and even domestically owned food retail chains against MNC retailers. While the defense of farmers' interests served as the leitmotiv of this new coalition, the latter remain conspicuously absent and without representative organizations.

In 1989, 60% of retail was controlled by the state, 30% by marketing cooperatives and 10% by smaller private retailers (Karsai, 2000). The Socialist organization of the sector reflected a similar regional monopoly structure than discussed in relation to dairy processing. The privatization process was differentiated and prolonged in time: differences between the legal statuses of marketing cooperatives, state-owned food stores, rural food retail networks and a specific status for the Budapest retail market resulted in differentiated privatization. The first stores to be privatized were small units employing less than 10 people under the so-called "pre-privatization" law of 1990. Only

Hungarian nationals could purchase these stores (although they were later often re-sold to MNCs during the 1990s in a process called “re-privatization”). This process concerned approximately 10 000 units, which had previously belonged to 400 retail companies (Karsai, 2000). In 1994, the privatization of rural (non-Budapest) food retailers was opened to foreign investors as well: In rural areas, the privatization of these regional networks occurred in bulk –foreign MNCs first entered the market in such brownfield investments where they purchased regionally distinct networks of stores: for instance the Komárom county retailers were bought by the Austrian Spar group, while British Tesco acquired Sopron county’s food retail stores (Bauer & Agárdi, 2000). By the mid- to late 1990s, two new phenomena marked the market. The first was the penetration of MNCs. The second was the emergence of new marketing format: super- and hypermarkets on the one hand and discounts on the other. British (Tesco) and French (Auchan, Cora) retailers introduced the super- and hypermarket store formats on the Hungarian retail market. In this model, a relatively small number of extremely large stores allows for realizing substantial profits through economies of scale. On the other hand, German (Metro, Lidl, DM, Penny Market, Tegelmann, Rossmann, etc.) and Dutch (Spar) retailers specialized in smaller stores in a discount format (and cash and carry to a lesser extent). The managerial logic in this format is very different: it relies on a centralized procurement system, extremely fast replacement rates and keeping a minimal stock of products on shelves, which enable these firms to offer consumer prices below competitors.

MNCs were pioneers in the diffusion of both of these two new models of retail management, which hadn’t have equivalents in Hungary previously. From brownfield investments, MNCs increasingly turned to greenfield projects in order to establish a national network. MNCs’ share in the sector’s turnover quickly rose from 25% in 1995 to 45% by 1998 (Gorton & Guba, 2002). Consumption behaviors favored in particular larger stores, which strengthened the position of British and French MNCs: by 2000, stores with an area superior to 800 m² accounted for 60% of the sector’s turnover (AKI, 2009).

In spite of these changes, one might be surprised to observe that while profits were increasingly captured by foreign retail chains specialized in super and hypermarket formats, domestic retailers didn't disappear from the market. Two different types of domestic retailers managed to survive: On the one hand, members of a national alliance of marketing cooperatives (ÁFEOSZ) operating smaller retail stores continued to control a large share of the market. We lack the space here to provide an in-depth overview of retail cooperatives in Hungary, but contrary to agricultural producer and processor cooperatives, they weathered the transition comparably better: the 1989 law on cooperatives gave them a new legal status classifying them as private property, which saved them from being transferred to the national privatization agency (Karsai, 2000). They accounted for 7524 stores by 1998 and their combined turnover was second only to German market leader Metro (Bauer & Agárdi, 2000). In 2001, ÁFEOSZ fully transformed from a representative body of retail cooperatives into a commercial group of retailers called COOP, working in a franchise license- and a common procurement system. Although its decentralized organization is markedly different from other firms, the COOP group's 5441 stores are the fourth biggest in the sector with a turnover in excess of 510 billion HUF today (Dobos, 2009). The other notable domestic owned retail group is CBA: unlike COOP which inherited the pre-existing Socialist marketing cooperatives, CBA is a commercial group set up by 11 investors in 1991 who purchased smaller retail stores in the wake of the 1990 law on retail privatization (Bauer & Agárdi, 2000). Contrary to COOP, which is specialized in small proximity stores, CBA diversified in all market segments ranging from hypermarkets to small units. With a yearly turnover of 547.5 billion HUF and a network of 3225 shops, it is today the second retailer behind market leader Tesco. CBA and COOP sought to strengthen their position by establishing a joint procurement system in 2009 at the national level – although individual stores enjoy a degree of autonomy in the selection of their products. A third domestically-owned retail network is Reál, a heterogeneous group of retail stores set up in 2001, whose ambitions at extending in the super- and hypermarket format are currently checked by a ban on further expansive retail store constructions called “Mall Stop”. Nonetheless, with its existing network of 600 supermarkets and 1300 proximity food retail units, Reál is the fifth biggest player in food retail with a turnover of 370 billion HUF in 2012. Briefly put, although only these three retailers are domestically owned among the 13 biggest retail chains in Hungary, and while they are not as

profitable as MNCs that operate with substantially less units, their combined market share still accounts for half of the market. This in turn led to tensions between domestic and foreign retail chains, which played an important role in the emergence of a new alliance between domestic dairy processors, the state and domestic retailers.

Towards an alliance between the state, domestic dairy processors and domestic retail chains against MNC retailers

The role of food retail chains received increasingly vocal criticism from domestic dairy processors in the early 2000s. Food retail chains were primarily accused of two things: setting unfair contractual clauses to their suppliers and aggravating the trade deficit of the Hungarian dairy sector by selling imported dairy products (essentially fresh milk) under Hungarian production prices (Györe, Popp, Stauder, & Nechay, 2009; M. Szabó, 1996; Versenyhivatal, 2011). The Hungarian Milk Council - which transformed into the central regulatory body of the dairy sector and is now controlled by Hungarian dairy processors – played a central role in lobbying the state for new, restrictive regulations on food retailers. The first mobilization of the Milk Council in that direction materialized in 2007, when they managed to enlist domestically owned food processors from other sectors, established alliances with the Ministry of Agriculture and sought to enforce an “Ethical Codex” with national quota requirements on food retailers⁵². While the project was eventually rejected by the National Competition Authority, the government’s own regulatory objectives aligned with the Milk Council after 2010: the state’s regulatory policy towards MNC retailers is discussed in the next part in greater length. What is remarkable is that the domestically owned food retailers CBA, COOP and Reál entered the emerging coalition between the Milk Council and the state: in 2014, all four became formal members of the Milk Council. Even more importantly, while public regulation between 2013 and 2015 has adopted increasingly aggressive measures against hypermarkets where MNC retailers are dominant – chief of which Tesco, the market leader – Hungarian food retailers were largely shielded from these as they are mostly specialized in smaller units. Far from a coincidence, this alignment marks the consolidation of an interest coalition dominated today by domestic dairy processors who control the Milk Council – Tibor Mélykuti, the Head of the Milk Council is also the

⁵² Interview with Ms. Folláth, ÉFOSZ, 22/11/2013

CEO of Alföldi Milk – with allies both in the ministries and among domestic food retailers.

The shape of the new market

What is striking is that MNCs – especially in the processing segment - didn't play the sort of positive upgrading role that the literature on dairy restructuring in CEE would have expected. Swinnen, Gow et al. argue that MNCs helped to implement a new, post-Socialist vertical coordination in CEE, which stabilized the relations between producers, processors and the retail sector (H. Gow et al., 2000). The Hungarian case shows on the contrary that MNCs didn't stabilize the production segment and didn't develop long-term, stable relations with Hungarian producers.

The problem was not only that MNCs failed to build strong alliances down the supply chain, which could have stabilized suppliers' expectations, but the very corporate strategies of dairy MNCs in Hungary were short-sighted and retrenched production onto the domestic market, one which they ultimately even abandoned one after the other in the early 2000s. MNC strategies contributed to downgrading both domestic productive capacities as well as the sector's overall trade performance. The type of frenetic acquisition-and-merger strategy best exemplified by the Nutricia group proved detrimental: acquiring a large number of processing plants entailed the reduction of the product portfolio in each individual plant, which led in turn to redundant capacities and new problems for coordinating a network of independent facilities, an argument that was systematically used by firms such as Danone or Nutricia to later shut down most of the plants they had acquired. A common suspicion among public officials and domestically owned firms is that MNCs consciously implemented a "scorched earth" strategy in order to physically dismantle their potential competition⁵³. The pattern in MNC penetration is strikingly similar between very different firms: an expansionist strategy in the 1990s was followed by a gradual retreat from the market in the 2000s, resulting in a "re-domestication" of the sector. From a commercial perspective, it is also clear that MNCs were primarily interested in exploiting the Hungarian domestic market, not in using Hungary as a production base for exporting to CEE or Western Europe. While MNCs supplied the domestic market with higher value added products, they didn't

⁵³ Interview with László Lukács, Hungarian Milk Council, 13/10/2013

aim at exporting them. The trend in exports shows an exponentially worsening position: A trade deficit in higher value-added products and an increasing specialization of Hungarian exports in lower value added goods (fresh milk, milk powder). It is striking that that the relative rebound in external competitiveness corresponds to the period when MNCs leave the domestic market in the post-2010 period and domestic actors repurchase the plants left by MNCs. However, currently the rebound in exports is still fuelled by low value added goods (essentially fresh milk) and there are only timid signs of value added upgrading.

Second, when MNC processors began leaving the market at the end of the 1990s, the state entered a coalition with Hungarian dairy processors (and retailers) which encourages ever more aggressively the market exit of MNCs: although processing MNCs leave largely on their own, the 2010s are marked by the efforts of this domestic coalition to force MNC retailers also out of the market. This process is discussed in the following section.

Briefly put, the question of competitive upgrading in developing economies can be traced back to a scarcity of domestic capital and technology: at the theoretical level, both public and private actors can play an active role in engineering domestic upgrading. Private actors such as MNCs can theoretically provide both capital and technology – although the extant scholarship shows that a tangible glass ceiling exists, beyond which MNCs are not motivated to empower their domestic suppliers. The state on the other hand has an active role in shaping property rights institutions on the one hand, while it can also organize the targeted channeling of available foreign capital to the technological modernization of domestic actors. In the Hungarian case, the state created a chaotic and fragmented property rights structure, without a coherent long-term strategy for upgrading the competitiveness of domestic firms. Instead, when the competitive downgrading of the sector became obvious, it joined an interest coalition with domestic processors and retailers to force MNCs out of the market: this is a low-cost developmental strategy where the negative developmental outcomes of *integrationism* are mitigated with protectionist regulation instead of large scale investments destined to the least competitive segments of a domestic sector.

Part 4. Re-regulating the Market

From *laissez-faire* to the first protectionist experiences: public regulation between 1990 and 2003

The public institutional actors that regulated the dairy market throughout the 1990s were few in number and weak in competence: the Hungarian Privatization Agency (ÁVÜ/ÁPV Zrt.) oversaw the privatization of the 26 pre-selected dairy processing plants. At the sector level only one central organization was established for regulating the dairy market: the National Milk Council, set up in 1992. This organization was established out of necessity, in view of EU accession, in order to implement the quota system of production, which had been in place in the EU since 1984 as discussed below. However, outside of this administrative role, the Milk Council, although formally gathering all major processors (MNCs and domestic) as well as dairy producers, had no real political or regulatory role before 2013.

The specificity of the Hungarian dairy sector was that organizations of interest representation and coordination for the different actors of the supply chain were scarce, weak and their inter-institutional coordination almost absent. Dairy processors joined the National Association of Food Processors (ÉFOSZ), while they were equally represented in the Milk Council. Producers (farmers) on the other hand proved unable to establish strong representative organizations: although producers were also members in the Milk Council, since the latter played no formal role in managing the vertical coordination of the dairy supply chain between retailers, processors and producers, the voice and interest of farmers was largely underrepresented. As discussed previously, this was also a direct result of land privatization, which destroyed cooperatives and fragmented farmers' property. Tellingly, the plight of dairy farmers has been a key argument in the lobbying efforts of Hungarian dairy processors against food retailers: however autonomous farmers' organizations are inexistent. In fact, a National Union of Dairy Producers (MTOE) was set up in 2004 by none other than domestic milk processing cooperative Alföldi Milk (Mélykúti, 2004): since then, this organization has been entirely inactive.

Throughout the 1990s, the state didn't implement any coherent national developmental program in the dairy sector: We have already mentioned the erratic and poorly designed interventions of the state in the earliest years of the transition: when the state put an end to subsidizing the consumer prices of milk products in 1991, the direct consequence was an overproduction crisis where the state was forced to step in again – this time for subsidizing producers to limit production and slaughter cows. Far from solving the problem, this in turn led to major disruptions in the supply of fresh milk to processors so that the government eventually backtracked and scrapped these subsidies entirely in 1992. The public subsidization of production costs played a minor role throughout the 1990s: while in 1991, dairy exports benefitted from 35% subsidization, by 1996 export subsidies only concerned cheese (20 HUF/kg) and even these were disbanded in 1997 (K. Szabó, 2010, p.16) - which is understandable, since MNCs controlled overwhelmingly the processing sector at the time and they targeted primarily the domestic market.

The state's regulatory role in dairy markets was largely limited to the distribution of property rights in the course of privatization, and after 1992, to implementing the European quota system of production through the Milk Council. In spite of the availability of pre-accession funds, the dairy sector didn't enjoy any targeted developmental effort: in other words, the state had neither a coherent vision for strengthening the competitiveness of its dairy sector, nor strategies for compensating the losers of the transition process – that is the vast masses of smallholder milk producers who were gradually excluded from the market throughout the 1990s. Similarly, the public regulation of the sector was limited to the uttermost minimum – that is conformity with the EU quotas of national production caps. Briefly put, throughout the *integrationist* phase of its post-Communist restructuring, it was precisely when MNCs overwhelmingly controlled the sector that public regulation did the least for strengthening capacities, or improving competitiveness. The vertical coordination of the dairy sector was extremely weak, as both processors and suppliers mutually distrusted one another and routinely broke contracts: the state had outsourced the developmental role of providing the sector with capital and technology to MNCs and watched from a distance as the sector gradually collapsed.

The end of this “laissez-faire” period occurred in 2003-2005, when tensions in agri-food supply chains eventually forced public authorities to intervene. In 2003, a new law on Agricultural Market Regulations was adopted, followed by a revision of the Commercial Act in 2005. The two new pieces of legislation sought to regulate the relations between suppliers and buyers: authorized delays in payment were maximized at 30 days (a widespread problem in dairy had been that since milk is perishable, it has to be sold quickly – yet retail chains and processors alike often delayed payments to producers for months); the pricing of dairy products under production costs was banned in 2005 – which sought to remedy the increasingly worrisome trade deficit, as milk produced in excess in Poland was routinely sold by retail chains in Hungary under both Polish and Hungarian production prices, “unfair contractual clauses” between suppliers and buyers were banned as well as the mandatory payments of unsolicited fees by suppliers. The amended 2005 Commercial Act targeted supermarkets – MNCs in fact - since the regulation applied specifically to entities with “significant buyer power”. This “significance” was defined as: (1) a net turnover in excess of 100 billion HUF, and (2) “*a one-sidedly favorable position vis a vis suppliers in light of entry barriers, market share and the size of its network*”⁵⁴. Because these criteria remained vague, the regulation was clearly intended to hit foreign-owned retail chains, and was perceived as such both by the legislator and MNCs themselves⁵⁵. The legislation also mandated the Competition Authority to conduct proceedings against retailers using unfair business practices and unfair contractual clauses vis a vis their suppliers⁵⁶. The effect of these new regulations proved relative at best: a study commissioned by the National Competition Authority singled out that buyers creatively circumvented the legislation: Next to an “official”, legal contract that formally respected the 30 day payment limit, they also forced suppliers to sign a secret contract in which this provision was effectively cancelled and 60 to 70 day payment delays were bilaterally recognized between buyers and suppliers (Dobos, 2009).

⁵⁴ Source: http://ec.europa.eu/competition/ecn/brief/05_2011/hu_food.pdf accessed 03/11/2014

⁵⁵ In fact between 2005 and 2011, the second, market-specific criteria defining market power were used by the Competition Authority only once, and even then, the test applied was not explicated. In practice therefore, the first, revenue-based criteria is considered sufficient for determining „significant buyer power”. Source: Ibid.

⁵⁶ Ibid.

The legislative apparatus for targeting MNC retail chains was further strengthened when the Parliament adopted Act XCV/2009 on “Unfair Trade Practices in relation to Agricultural and Food Products”. The 2009 law largely reiterated the same provisions as the 2005 Act, with one crucial difference: the new act didn’t include any reference to the complex market variables for determining significant buyer power, which meant in effect that the Competition Authority could use it against virtually any retailer, irrespective of size or location. This added further latitude for threatening foreign MNCs while making sure that Hungarian-owned retail chains could be potentially exempted from this scrutiny.

In parallel to the actual acts adopted, another initiative that was eventually scrapped nonetheless marked an important symbolical turning point in 2007: key Hungarian processors from the National Milk Council mounted a coalition with other domestically-owned food processors and received the backing of the Ministry of Agriculture. Their aim was a new piece of legislation called the “Ethical Codex” – a self-regulatory standard regulating buyer-supplier relations in agri-food supply chains⁵⁷. However, the proposed legislation went well beyond the type of self-regulatory code that is widespread in agri-food sectors: specifically, the bill would have forced retailers to comply with a fixed quota of nationally produced processed goods. Although the coalition between Hungarian food processors and the Ministry of Agriculture seemed solid, the Competition Authority eventually rejected the proposal, arguing that it stood in blatant infringement to the principles of free competition and non-discrimination. The Authority argued that even if adopted, such a law would be immediately repelled by the ECJ since it ran counter to the basic rules of the Common Market (Versenyhivatal, 2009). In spite of this failure, the Ethical Codex was a clear indication that new coalitions were emerging in Hungarian agri-food sectors and that the efforts of Hungarian food processors to enlist public actors in order to enforce protectionist measures to fend off the buyer power of MNCs – most notably retail chains – were also received sympathetically by the state. The period between 2005 and 2010 marked the first visible shift in the state’s regulatory preferences, foreclosing two decades of relative passivity towards the struggles between domestic and foreign firms in the Hungarian market. It is

⁵⁷ Interview with Ms. Folláth, ÉFOSZ

also crucial to mention that this occurred under a Socialist-Liberal coalition government: in other words, the public actors in place at the time were not typical of the nationalist tradition embodied by right wing parties.

In effect, the 2005-2010 period marked the first phase in the publically regulated re-domestication of agri-food markets: the attempt at enforcing an Ethical Codex with national quota requirements might have been ultimately scrapped – however, it also emboldened Hungarian dairy processors: it showed them that they could mobilize domestically-owned firms in other agri-food sectors and find allies in the Ministry of Agriculture. With the electoral victory of the Fidesz government in 2010, which had capitalized on staunchly nationalist narratives, the alliance between domestic dairy processors and the state would become ever stronger: the designated enemies were MNCs and while processing MNCs had already begun leaving the market, the retailer MNCs left on the market continued to pose a threat to domestic dairies since they could use their buyer power in depressing purchasing prices from Hungarian dairy processors without translating them to consumer prices. The strategy followed by domestic dairy processors was to force retailers to change their procurement strategies and buy a larger share of domestically produced dairy products as well as to prohibit the sale of imported goods below Hungarian production costs. This aligned perfectly well with the strategy of the Fidesz government to reduce MNC market shares in designated markets. Furthermore, it also found strong support among Hungarian food retailers who hoped that they would inherit market shares from retailer MNCs if these were forced out of the domestic market.

The Effects of EU Regulation on Organization of Hungarian Dairy

The Quota System

The EU regulation of dairy markets had direct consequences on the bargaining position of domestic actors in Hungary, especially as the predominance of domestic ownership increased over the past few years in the course of re-domestication. The EU's regulatory instruments and strategies also changed importantly over the past decade. The need for

regulating dairy markets materialized in the 1970s when the EU market was flooded with milk, which pulled prices down: given that most of the member states had national provisions for intervention prices under which they would compensate dairy producers, the low market prices forced a costly subsidization practice at the national level. The solution found to this collective action problem was the creation at the EU level of national production quotas, which would prevent future crises of overproduction. The quota system was thus established in 1984.

However, during the 1970s, 1980s and 1990s, important changes also occurred in food supply chains at the global level, which also affected Europe: Berdegúe and Reardon call it the “supermarket revolution” (T. Reardon et al., 2012). The international expansion of supermarket MNCs also accelerated concentration in the retail segment, which directly affected dairy producers and processors since close to 80% of food and grocery distribution occurs today through retail chains in Hungary⁵⁸. The combination of a regulatory framework which encouraged market concentration, combined with the expansion of supermarkets resulted in dairy supply chains where farmer-producers were faced with increasingly powerful and concentrated processing and retail segments: concentration meant that buyers such as dairy processing factories or supermarkets could use their oligopsonistic buyer power to drive purchasing prices down, without translating these economies towards the final consumers. In other words, retailers in particular became the clear winners in the distribution of profit and value added in the supply chains. The shift in bargaining power from producers to retailers is also a global phenomenon, equally affecting rich and developing economies (T. Reardon & Timmer, 2012; T. Reardon et al., 2012). The current literature on agricultural development considers that a remedy to this problem lies with the establishment of inclusive property rights institutions such as cooperatives and sector-level unions which level the playing field vis a vis retailers and processors (T. Reardon et al., 2012). This view came to inform the EU’s new regulatory agenda in the dairy sector after 2008.

⁵⁸ Interview with Dr. Fórián, Agrár Európa

The Milk Package

The shift in the EU's preferences and modes of intervention in the dairy market occurred in the 2008-2012 period, notably in order to address the negative externalities produced by the quota system itself: The immediate concern stemmed from important fluctuations in global milk prices over the 2007-2009 period, however, the problems in dairy supply chains ran deeper: a new concern was the overall erosion of producers' bargaining power, an issue first voiced by the European Parliament (most notably French farmer activist José Bové) which commissioned a study in 2008 to assess the potential legislative and regulatory measures that could address this situation. The Commission took further initiatives: it set up two High Level Groups – the High Level Expert Group on Milk and the High Level Forum for a Better Functioning Food Supply Chain in 2009⁵⁹. The mandate of both organizations was to produce a holistic overview of agri-food supply chain structures in a consultative format, in order to produce a list of legislative recommendations for new forms of EU regulation in these markets. In both organizations, the key goal was to find new policy mechanisms for strengthening the bargaining power of smaller actors (typically domestic producers and smaller processors) vis a vis MNCs (typically retail chains).

What followed was a lengthy consultative process with the stakeholders of the supply chains as well as public representatives in each member state, but since the process was not mandatory, and many remained skeptical over the EP's capacity and the Commission's willingness to adopt more stringent regulations vis a vis the powerful MNCs that governed dairy supply chains, participation was uneven: as Dr. Tóth, one of the Hungarian participant experts from a private agri-food consultancy noted, the Hungarian government for instance seldom delegated senior officials and showed low investment in the activities of the Milk Group⁶⁰.

⁵⁹ Comprehensive archives of the High Level Forum for a Better Functioning Food Supply Chain available at: http://ec.europa.eu/growth/sectors/food/competitiveness/supply-chain-forum/index_en.htm accessed 06/07/2013

⁶⁰ Interview with Dr. Péter Tóth, Agrár Európa

The recommendations of the Milk Group were summarized in a White Paper, which proposed new legislative measures in three key areas: (1) The public regulation of private contractual relations between producers and buyers, (2) strengthening cooperatives and (3) establishing sector-specific organizations with sufficient legitimacy to self-regulate the dairy market without further need for hard law interventions⁶¹. These three themes eventually led to three new pieces of EU legislation in 2012, collectively referred to as the Milk Package: Regulation 511/2012 on “interbranch organizations” in the dairy sector, Regulation 880/2012 on transnational producer groups and Regulation 261/2012 on contractual relations in the dairy sector. The three objectives of the Milk Package were respectively: (1) to ban unfair business practices in the dairy supply chain, typically involving the use of buyer power by retailers and larger processors such as delayed payments and unjustified costs for producers, (2) strengthening the bargaining power of the weakest segment in the supply chain, namely producers, by incentivizing the creation of producer cooperatives, and (3) creating new institutions for interest representation and coordination at the sector level. From the Hungarian perspective especially, the most consequential regulation was the last: not only does the EU encourage member states to establish what it calls “interbranch organizations”, but the Milk Package specifically mandates these new institutions with the capacity to regulate private contracts in the sector. In practice, the Milk Council became the official interbranch organization of the sector in 2013⁶². It published a standard “fair contract” in April 2014, which serves as a model for the entire sector, while since June 2014, it has also published a monthly recommended reference purchase price for two key products (UHT milk and processed cheese). Somewhat confirming the expectations of the skeptics, the most aggressive forms of public legal intervention in the private contractual relations between retailers, processors and producers were eventually scrapped at the EU level. The interventions chosen sought a more conciliatory strategy by strengthening producer capacities instead of punishing MNCs. However, these new regulatory tools, oscillating between soft and hard law

⁶¹ Comprehensive archives of the High Level Expert Group on Milk available at: http://ec.europa.eu/agriculture/markets/milk/hlg/index_en.htm accessed 06/07/2013

⁶² Source: http://www.tejtermek.hu/attachments/article/303/2013_3%20TT%20tagi%20tajekoztato.pdf accessed 02/11/2013

instruments nonetheless offered a new boost for domestic Hungarian public and private actors in their attempt to re-regulate the supply chain.

Re-Domesticating the Dairy Sector

In line with the EU Milk Package, The Hungarian Milk Council acquired the new EU status of official “interbranch organization”. Up until 2013, the organization - although regrouping all the important actors, MNCs and domestic firms and producers alike – had virtually no regulatory mandate. Its role had been limited to the allocation of milk quotas between the various firms operating in Hungary. It is noteworthy that rebranding the Council as an “interbranch organization”, participated in maintaining the illusion of a genuine grassroots organization – which it had never been. It is also illustrative of the poor self-organization capacity of the sector that the Milk Council was an easy candidate for the title because in spite of its weak mandate until 2013, it had been virtually the only sector-specific organization in place. It is worth mentioning that other countries saw the ex-ante creation or the re-labeling of existing institutions as “interbranch organizations” as unnecessary given the extant thick institutional landscape in grassroots producer- and processor- organizations: Poland notably considered that there was no need for yet another representative body. In the Commission’s mind, setting up interbranch organizations in national dairy markets genuinely serves the vertical coordination of the supply chains and favors consensual self-regulation (thus limiting potential conflicts and crises between the different actors, which would require an intervention by the member state or the EU itself): the key criterion for recognizing an interbranch organization is the representativeness it guarantees to all stakeholders in the supply chain. In Hungary for instance, the Milk Council thus regroups 3750 producers, 40 processors and 6 retailers⁶³. However, beyond this apparent democratic character, membership is actually reflective of the new power relations favored by the dominant public and private actors: as soon as the Council transformed into an interbranch organization, and as it became apparent that the new organization would have regulatory capacities, all the major processor MNCs left the Council. The deputy-director of the Council openly recognized during our interview that the new legal status of the organization actually revealed the vastly

⁶³ Interview with Mr. Lukács, Hungarian Milk Council

different interests of the stakeholder: *“It was clear after 2013 that multinational companies didn’t share the same objectives as us: they left the Milk Council one after another when it became clear that we were at the beginning of a new period and that the Milk Council would defend strong new protections for Hungarian milk producers and processors (...) It is not surprising because they have an interest in no regulation whatsoever, whereas we are here to defend Hungarian interests⁶⁴.”* The new Council is governed by a Directory Board comprised of twenty-one delegates, nineteen of which represent Hungarian-owned processing firms⁶⁵. The two exceptions are Mrs. Posztos, marketing director at Tetra-Pak Hungary, a subsidiary of the Swedish multinational that produces packaging for virtually all milk and dairy brands, and Mr. Carlo Volpe, the Italian CEO of Óvár Milk, a secondary processor recently acquired by smaller Italian family-owned processor company Valcolatte, which specializes in ricotta and mozzarella. The Head of the Board is at present Tibor Mélykúti, who is also CEO of Alföldi Milk, the vast domestic cooperative that purchased the processing plants left behind by Parmalat and Sole. What is more surprising is that producers, especially smallholders equally lack representation in the newly created official self-regulatory body. In actual fact, this heavily unbalanced management structure reveals a new alignment of interests, which is characteristic of the Hungarian dairy sector in its phase of re-domestication in the post-2010 period.

The transformation in membership reflects deeper changes in the Council’s objectives: the shared goal on the part of the Fidesz government elected in 2010 (later reelected in 2014) and Hungarian processors was to accelerate the dairy sector’s re-domestication, in other words, to encourage the remaining MNCs in the processing segment to leave the market and to put new constraints on retail MNCs in the distribution of profits in the supply chain. As mentioned previously, this goal was not new: the first attempts in this direction had emerged already in 2003-2005 under a Socialist-Liberal coalition government, however by 2010 the situation had changed. On the one hand, the exit strategies of MNCs accelerated after 2010 independently from the incumbent governments’ efforts, yet the crisis of dairy supply chains identified by the EP and the subsequent Milk Package gave a boost to this effort. A new coalition emerged between

⁶⁴ Ibid.

⁶⁵ Source: <http://www.tejtermek.hu/magunkrol/elnokeg> accessed 10/05/2015

Hungarian cooperative Alföldi Milk, tycoons in the agri-food sector such as Mr. Csányi at the head of Sole-Mizo (and more largely his Bonafarm empire), domestic retail chains CBA, COOP and Reál as well as a government elected with the promise of breaking away from the national economy's dependency on MNCs. National preference and encroachments to free market principles such as non-discrimination became acceptable: neither the government nor the Milk Council felt that they needed to hide their objective, namely a re-allocation of market shares from multinationals to Hungarian firms, using various regulatory incentives and disincentives.

The timing also played an important factor in facilitating this endeavor: the 2007 financial crisis left Hungary on the brink of bankruptcy by 2009, and as negotiations with the IMF began, it seemed that the country was bound to undergo a lengthy phase of austerity measures to redress budgetary deficits and public debt. It was in this context that the Fidesz government won the 2010 elections with the promise of refusing austerity but instead fundamentally reforming Hungary's integration to transnational markets – chief of which the EU – in order to reduce dependency on foreign capital. The fundamental objective of the Fidesz government was to stabilize public expenditure by increasing revenues through “unorthodox measures” such as the nationalization of private pension funds in 2011 and the implementation of “extra taxes” on MNCs. The stormy context of the Eurozone crisis left the EU more preoccupied with the sovereign debt crisis and the risk of contagion among the predominantly Southern economies (the so-called “PIIGS” group) than with Hungary, which gave the government a window of opportunity for implementing policies that would have otherwise likely been impeached by the Commission and the ECJ. The government used different narratives for legitimizing its programs: outright nationalism was a key component in a dramatic macroeconomic context when difficulties were blamed on exaggerated external dependency and a colonization of the national economy by MNCs, which failed to upgrade productivity, domestic value added contribution and wages. At the level of the dairy sector however, this nationalist stance was also complemented with a more managerial and technical discourse on the necessity for stabilizing volatile supply chain relations in a market on the verge of collapse. That is how the policy recommendations of the EU Milk Package offered an unexpected help to advance re-domestication: the interests of an openly nationalist government, domestic dairy processors and the new

objectives of the Commission and EP to strengthen domestic actors vis a vis MNCs were thus aligned. Contrary to other sectors and policy areas where the Fidesz government's nationalist program found staunch enemies in Brussels and EU15 countries, at the level of the dairy sector the new objectives of EU regulation laid down in the Milk Package actually empowered domestic public and private actors in re-domesticating the market under the guise of defending domestic SME interests against powerful MNCs.

Thus, the Milk Council, putatively a representative body of all major stakeholders, represents today the interests of a distinct group of actors: Hungarian-owned dairy processors. As our interviews with the organization revealed, this group has clearly identified allies (the Ministry of Agriculture, and by extension the government as well as domestic retailers) and enemies (processing and retail MNCs). It is important to stress that while the leadership of the organization consistently speaks of defending "national" or "Hungarian" interests, the question of smallholders and small milk producers is absent from this discourse. Our interviews with the management also revealed that the regulatory ambitions of the Milk Council far outstretch its legal mandate, and that in practice, the Hungarian processors it represents work in tandem with the government and various public bodies for achieving a key goal: restraining the market power of MNCs. In practice, not only is there an objective alignment of interests between a nationalist government and domestic dairy processors for redistributing the domestic dairy market, but the Milk Council, by its own account, acts a strong lobbying organization, which aims at adopting new legislation in the Parliament against MNCs. In October 2013 when our interviews took place in their offices, the deputy-director thus admitted that the long-term goal of the Council was to encourage the adoption of new regulation on mandatory national product quotas in retail chains and restraining the value added capture by retail MNCs in the supply chain, an objective equally shared with their partners in the Ministry of Agriculture and even the new management of the National Competition Authority: *"We already tried to implement a quota system in 2007, which was unfortunately eventually abandoned. In spite of this, I can proudly say that us, Hungarian dairy processors, we were the real initiators of this project at the time. Our new strategy is different today: contrary to 2007, we are not trying to negotiate with the other food processing sectors, we concentrate on pushing efforts specifically for dairy. I am confident that we can achieve our goals today because we have very good working*

relations with the Ministry (of Agriculture) (...) contrary to 2007, I know that today the new people at the Competition Authority will not rebuff our proposals because this time they are on our side⁶⁶.

In light of these, the role of Hungarian dairy processors has to be re-assessed: they are not only the key group, which now controls the official regulatory body of the entire sector, but through personal connections, affinities and an objective alignment of interests, they also work as a less visible lobby, encouraging the government to adopt ever more stringent regulations against their prime enemies – MNC retail chains (given that MNC processors have gradually deserted the Hungarian market). In that endeavor, domestic retail chains proved natural allies.

In the 2010-2015 period, the Fidesz governments adopted a series of acts, which clearly sought to incapacitate MNC retail chains, curb their market share and/or force them out of the country. The first of these was the introduction of a special tax on larger retail companies in 2010: This new tax was part of a series of new levies that the government called “special taxes”. In 2010, as the country was badly hit by the financial crisis, the Eurocrisis and a specifically domestic problem rooted in large-scale household debt denominated in foreign currency (while inflation rose sharply). The introduction of “special taxes” was predicated on the idea that MNCs operating in Hungary should also contribute proportionally to their profits in extraordinary times. Among a series of other taxes, the government introduced a “special tax” on retail chains: it targeted specifically firms with a turnover in excess of 500 million HUF with a progressive rate between 0,1% and 0,4% until 1 billion HUF and 2,5% beyond. The specificity of the tax was also that the turnover considered was not based on the operations of individual companies: where the firm belonged to a larger group of companies, the turnover considered was the total registered by the group as such. Although the tax was later phased out, it hit foreign retail chains particularly hardly – yet the ECJ left it to the discretion of Hungarian courts to determine whether it had actually discriminated against foreign companies. A second regulation came in the shape of a law commonly referred to as “Mall-Stop Act”: this law adopted in 2011 banned the construction of new retail facilities above 300 sq. and forced the construction of new retail facilities to seek the preliminary approval of a

⁶⁶ Interview Mr Lukács, Hungarian Milk Council

special committee composed of representatives from the Ministry of Agriculture and the Ministry of Economy. A third piece of regulation affecting retailers was adopted in 2013, when the concessions on tobacco sales were unilaterally nationalized and re-distributed in tenders supervised by the government. Finally, 2014 saw the introduction of even more aggressive regulations: In November 2014, the Minister for the National Economy, Mihály Varga, introduced a bill that sought to add new modifications to the 2005 Commercial Act. The bill contained an extraordinary provision: the forced closure of retail facilities above 400 sq. if they failed to show net profits in two consecutive years. The Ministry knew full well that in the 2012 and 2013 commercial years, retail MNCs all accumulated important losses: the aim was clearly to devise a legal instrument that could not only restrict their market share but simply force MNCs out of Hungary⁶⁷.

It is especially telling that the bill argues that new regulation is necessary for defending the interests of Hungarian SMEs, who are often victims of retail chains' unfair business practices⁶⁸: *"In Hungary, unified rules apply to hypermarkets, large supermarkets, discounts and small family owned proximity retail stores. However, in this entirely free competition, the strongly capitalized retail chains continue to expand, while small stores are forced to close. In parallel, unemployment continues to grow, because large discounts and hypermarkets operate with higher productivity and they are less labor-intensive in light of the lower quality of services provided (sic). The retail sector is not characterized anymore by the competition between firms with a similar profile, but a competition between different marketing models. A family owned store is facing the competition from a discount company that cheaply sources its supplies from the whole of Europe or the hypermarket chain that sets up bus transportation for customers to reach its stores. Regulation doesn't provide sufficient protection because the same rules apply to all retail facilities. If we are to protect national SMEs while complying with EU regulations, we have to formulate different rules for different retail formats. The experience of the past years shows that large retailers are not big employers. Only the strengthening and development of SMEs can guarantee long-term employment. We have to step in to defend the interests of national SMEs and consumers. The strongly capitalized retail chains can afford to operate*

⁶⁷ Bill for the modification of Act CLXIV/2005 on Fair Market Behavior

Source: <http://www.parlament.hu/irom40/02086/02086.pdf> accessed 22/10/2013

at a loss with dumping prices, thus they force out of the market those firms which can't compete with (such) prices, since they depend on profits.⁶⁹

Although President János Áder refused to sign the bill and sent it back to the Parliament, the law was eventually adopted after modifications. Finally, in December 2014, a new law regulating opening hours in the retail sector banned shops larger than 400 sq. from remaining open on Sundays⁷⁰.

The new, aggressively adversarial stance on the part of public authorities took retail chains off-guard. Tesco Hungary is not only the market leader in food retail but also the country's single biggest private employer with 40 000 employees, and is also the market leader in grocery and food retail. As the most prominent of the retail MNCs, it also received the most criticism for its pricing- and contractual practices: on the one hand, it contributed actively to the import of Slovak and Polish milk priced in Hungary below national production prices, which played a key role in deteriorating the sector's trade balance. On the other hand, it was also accused repeatedly of offsetting unfair costs onto its suppliers. However, the company's management understood that they were too exposed as early as 2007, in the wake of the Ethical Codex proposal. As a reaction, Tesco implemented an unprecedented program called "national supplier development" in 2009. The aim of the program was to upgrade small producers hand-picked at regional fairs so that Hungarian SMEs could gradually grow to supply increasingly bigger markets through Tesco's network of supermarkets. The program is meant to offer a four-year upgrading platform: in the first year, the supplier serves a municipal network of shops, the second year comes the regional level, the third is national, after which comes the export market. Tesco claims that there is a constant transfer of know-how through standard- and marketing trainings destined for the suppliers, who are also offered preferential treatment and considerably longer contracts (yearly contracts) than others. By 2013, 100 small producers had participated in the program with 500 different products among which milk and cottage cheese. The revenues generated 2,2

⁶⁹ Ibid.

⁷⁰ Act 2014/CII. Source: http://net.jogtar.hu/jr/gen/hjegy_doc.cgi?docid=A1400102.TV accessed 01/07/2015

billion HUF in 2012 and 3 billion HUF in 2013⁷¹. The launch of the program was a rational reaction to mounting criticism and the threat of public regulatory intervention, and given the very small size of participants, it is equally obvious that it was barely more than a preemptive PR attempt by Tesco Hungary to avoid further sanctions. This strategy proved ultimately a failure: in spite of a symbolic contract of “strategic partnership” signed between Tesco and the government in 2012, the company was the primary target of the successive regulations adopted between 2011 and 2015, which openly aimed at reducing its market share. Ádám Lendvai, the responsible for the national supplier program summarized the position of the company on what he perceived as the government’s hypocrisy in punishing retail MNCs while avoiding upgrading investments in the production segment of agri-food supply chains such as the dairy sector: *“While there has been a lot of unfair finger pointing in our direction, it has to be said that neither the government nor any other company invested in a comprehensive upgrading program for small producers such as the one we implemented here”*⁷².

Conclusion: The Developmental Failure of Integrationism

The pathway of the Hungarian dairy sector offers an interesting case study for understanding how domestic agency shaped developmental strategies, how these preferences changed over time and how they ultimately affected developmental outcomes for the sector. A clear feature in the post-1989 period is periodicity: a first long period between 1989 and the early 2000s corresponds to an integrationist developmental model as described by Amsden (2001). In this period, the state restructures property rights – all the while domestic public actors don’t have a clear vision of long-term developmental goals. They transfer dairy processing to MNCs while they leave producers deeply fragmented without economically viable plots and without cooperatives that could pool their resources. Domestic actors are weak and disorganized in dairy production and processing. Instead of providing capital and technology for domestic actors through spillovers, direct and indirect linkages – MNC strategies deplete the remaining resources and precipitate competitive downgrading. Public agency was

⁷¹ Interview with Mr. Ádám Lendvai, Tesco Hungary

⁷² Ibid.

also shaped by a particular opportunity structure resulting from historical institutional legacies: among these, the combination of high levels of foreign debt accumulated since the 1960s and a successful nationalization of productive assets in the dairy sector in 1948 contributed to the state's preference for an integrationist strategy, which could raise foreign capital for financing the debt service by selling state-owned assets as quickly as possible. Thereafter, the problem of the sector's developmental upgrading was outsourced to MNCs. A consequence of this disintegration between an atomized production segment, and processors transferred to MNCs was that the state actually foreclosed the emergence of any potential domestic developmental coalition between the various actors of the supply chain – a model, which did materialize in Poland.

MNC processors' choice to leave Hungary altogether by the early 2000s shows that their investments in the mid 1990s were more of a trial-and-error experiment in which they took over an entire market before realizing that domestic consumption was not strong enough to justify further investments, while they didn't use existing production capacities for utilizing Hungary as an export base in light of the stronger comparative advantages of bigger CEE dairy sectors such as Poland. When they exit, they leave behind a market on the verge of collapse.

By contrast, a second phase is characterized by the re-domestication of the dairy market: a process which owes on the one hand to the decision of processor MNCs to leave Hungary and re-allocate resources to neighboring countries, but also to a new developmental model, which is a direct reaction to the perceived negative outcomes of the preceding integrationist phase. In this latter period, a new coalition emerges between domestic firms and the state, which seeks to limit on the contrary the market penetration of MNCs, or alternatively to incentivize and accelerate their exit. The primary goal in this second period is the re-allocation of property rights back to domestic actors.

What the Hungarian case study shows, is that very different rationales prevailed in these two moments: the management of privatization by the state instituted a market largely controlled by MNCs and a minimal state while the post-2010 period saw an aggressive re-regulation of the market that actively sought to exclude MNCs. It is also important to

stress that the regulation of relations between domestic and foreign actors could have taken on other shapes: an alternative method for improving the bargaining power of domestic actors would have involved massive national developmental programs targeted at Hungarian milk producers and dairy processors. The Polish pathway examined in the next chapter shows that such a strategy was indeed possible elsewhere. A particularity of the Hungarian pathway is that investments in the competitive upgrading of domestic actors failed to materialize even in the most overtly protectionist phase of re-domestication: in other words, rather than upgrading domestic actors, public actors chose the less costly option of pushing MNCs out.

After MNCs leave- or are forced to leave the market, the trade competitiveness of the sector does improve – albeit timidly. There is however a fundamental caveat: in spite of the seemingly radical shift from an integrationist to a more autonomist developmental strategy, what remained constant in Hungary was the absolute marginalization of farmers and smallholders, who remained consistently excluded from the defining interest coalitions that governed the sector. If integrationism reflected an objective alliance between the state and MNCs, the re-domestication of the 2000s is an alliance between the state, domestic processors and retailers: in both periods, farmers are merely spectators. Without capital and without voice, they are the consistent losers of the post-1989 process of restructuring. Nonetheless, there are some signs that cooperation and collective mobilization might gradually take hold at least among the bigger survivors: the case of Alföldi Milk, once a self-organized collective of MNC suppliers and now one of the flagship processors of the sector, allows for some optimism in that regard.

In the second chapter, we argued that domestic public agency can shape developmental trajectories in at least three dimensions: (1) by solving the problem of capital and technology needs of domestic firms, (2) by modifying property rights and (3) by regulating relations between domestic and foreign actors. In Hungary, the state chose to outsource capital and technology provision to MNCs – thus opting for an integrationist model for the sector's insertion in transnational markets. It also restructured property rights extensively in the course of land- and processing privatization: however in both cases, domestic actors were excluded rather than integrated in the new property right

institutions. Finally, the state became highly active in re-regulating MNC-domestic relations in the post-2010 period: largely as a compensation for the developmental failures of integrationism.

Although it is illusory to derive far-reaching conclusions for the entire Hungarian economy based on the relatively marginal experience of its dairy sector, we contend nonetheless that the trajectory experienced at this level convincingly mirrors macro-phenomena, which affected the entire national economy in the post-1989 period. The shift from *integrationism* to re-domestication is not a peculiarity of the dairy sector, but a defining feature in a country which twice elected a government that promised to liberate it from the yoke of multinationals and promised instead an autonomous, “national” developmental pathway. In light of the gap between this proclaimed goal and actual processes, we see peculiar similarities between the micro-level in dairy and the national macro level: in both cases, it becomes clear on closer scrutiny that what is effectively happening is not so much a shift from a developmentally inefficient, dependent mode of integration to transnational markets – to a more ambitious, more inclusive and economically more efficient model - but a redistribution of property rights from a small circle of MNCs to a similarly small circle of domestic firms. In that regard, the modest story of Hungarian dairy restructuring might also shed light on the political economy of a self-declared illiberal democracy.

Chapter 4.

The structural problems of Polish and Hungarian dairy sectors were very similar in 1989 as both countries had to overcome a dual challenge – competitive on one hand, and organizational on the other. Prior to 1989 the Polish dairy sector had been protected from competition as much as from consumer preferences: obsolete technology, patently low productivity, a virtual lack of food safety standards were not problematic as long as subsidized domestic production and consumption, guaranteed export markets under COMECON and legal safeguards against competition were in place. Under free market conditions however, these glaring competitive disadvantages reasserted themselves: the dairy sector urgently needed massive upgrading investments to adapt and survive. On the organizational level, new modes of coordination between the state and private actors had to be invented. While these challenges were equally present in Hungary, Poland embarked on a very different trajectory: in twenty-five years, a sector overwhelmingly dominated by domestically owned cooperatives inherited from Communism became one of the biggest dairy exporters in the world. The state's agency in shaping the sector's restructuring throughout the 1990s proved vital: since the early 1990s, the Polish state has implemented long-term upgrading investment programs financed with foreign capital secured from a variety of sources (bilateral aid, adjustment loans, EU funds) and has established a host of new public regulatory and financial organizations tasked with the modernization of agri-food sectors. Instead of getting rid of obsolete cooperatives, the state coopted them in shaping a modernization agenda for the sector. The success of this strategy became evident in the wake of EU accession in 2004: while many feared that increased competition might marginalize domestic actors, the competitive position of Polish dairy in transnational markets improved dramatically instead, while domestically owned Polish dairies maintained their dominant position in their home market. The Polish trajectory differs from the Hungarian case not only in the developmental outcomes it attained but the very mode of transnationalization: the integration of the Polish sector to transnational markets showing a lot of similarities with “traditional” autonomist developmentalism - when Hungary by contrast embraced an integrationist pathway.

In a first section, the trajectory of the Polish sector is described in light of indicators, which testify of a surprisingly robust competitive upgrading process. A second section discusses the sector's institutional history in the *longue durée*: long-term legacies shaped in Poland a different privatization agenda than in Hungary. In a third section, we examine upgrading policies implemented by a developmental alliance between the state and dairy cooperatives. Finally, we discuss some of the competitive constraints and opportunities inherent to different strategies adopted by Polish dairies⁷³.

Part 1. Developmental outcomes in the Polish dairy sector

Outcomes for domestic actors

As in Hungary, restructuring entailed important social costs in Poland, with a large number of small producers forced out of business: between 1995 and 2005, almost half of dairy producers left the sector (Table 4.1.).

Table 4.1. Dairy Producers in Poland 1996-2005

	1996	2002	2003	2004	2005
Nr. Producers ('000)	1309	876	810	735	712
% Producers compared to base year 1990	71,5	47,8	44,2	40,1	38,8
Nr Producers delivering to processors ('000)	560	376	356	312	294
In % of total producers	42,78	42,92	43,95	42,45	41,29

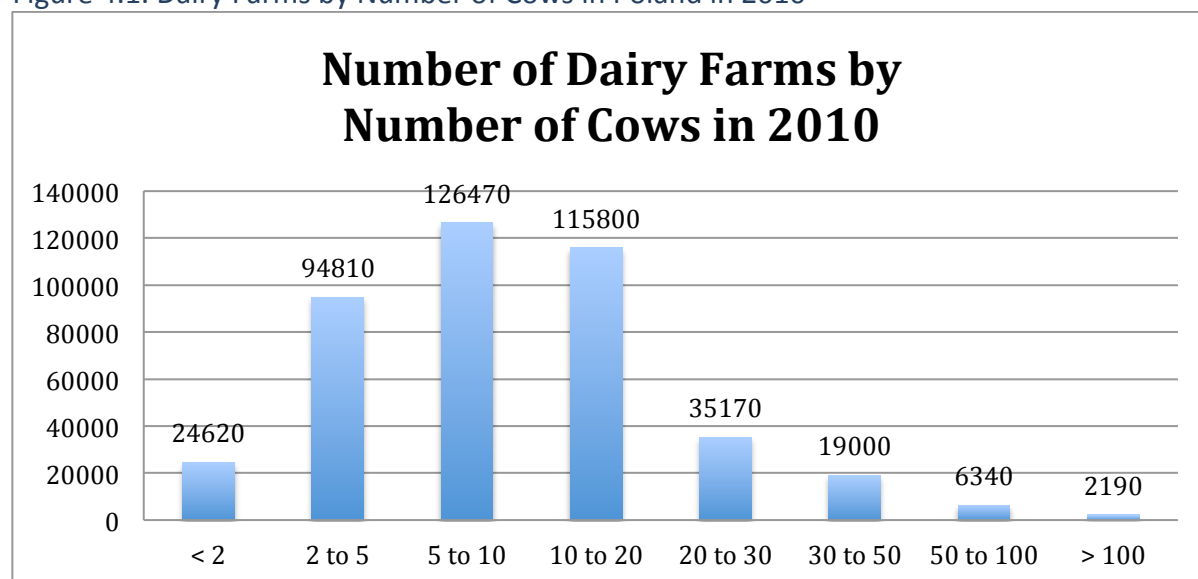
Source: (Wilkin, Milczarek-Andrzejewska, Malak-Rawlikowska, & Falkowski, 2006)

While significant, it has to be reminded that in Hungary this process was even more pronounced: Bakucs et al. (2012) estimate the decrease at 60% over the same period in

⁷³ The organizational difference with the preceding chapter reflects the temporal difference between Poland and Hungary: In Hungary, public interventionism occurred after competitive downgrade. In Poland, the state retreats after EU accession.

Hungary. The social costs of restructuring were (logically) spread unevenly, as the smallest farmers were the most affected. The production segment thus underwent concentration: the average number of cows per farm gradually increased as a result of small-scale farmer elimination. The smallest category of dairy farms owning between 1 and 2 cows accounted for two thirds of all farms in 1987, but only 5,8% by 2010. As a result, the average number of cow per farm increased to 31 by 2010 (Figure 3.6).

Figure 4.1. Dairy Farms by Number of Cows in Poland in 2010



Source: CLAL

However, it has to be reminded that Polish levels of concentration are below EU15 or even CEE levels by orders of magnitude: as we showed in the previous chapter, Hungarian farms had 354 cows on average in 2010. From that perspective, while the loss of the smallest producers has been important, the structure of Polish dairy production still reflects an extremely fragmented ownership structure.

Lower levels of concentration than in Hungary not only characterize production but dairy processing and the retail sector as well: Bakucs et al. (2012) find a decrease of 30% in processing firms between 1997 and 2007 in Poland for a total of 232 “survivors”. In Hungary, only 58 processing firms remained by 2007 for 170 in 1996. As a consequence, in 2006, the C4 concentration ratio of the four largest processors amounted to only 22% of total raw milk production in Poland while it had stood at 60% in Hungary already by 2001. A fundamental particularity of the Polish sector is that

domestically-owned processors accounted for 80% of market shares and foreign MNCs only 10% in 2004 (Seremak-Bulge, 2005): this constitutes a crucial difference with Hungary where these proportions were symmetrically inverted with MNCs controlling 80% of the sector by 2000⁷⁴. The cooperative format has another implication: farmers-producers own processing facilities – as such, production and processing are integrated within the same firms. This is a crucial difference with Hungary, where cooperatives never owned a majority of processing plants (not even under state Socialism): therefore in Poland, the functional differentiation between the production and processing segments of the market is less important than in Hungary, where data on these two segments speak of completely different actors.

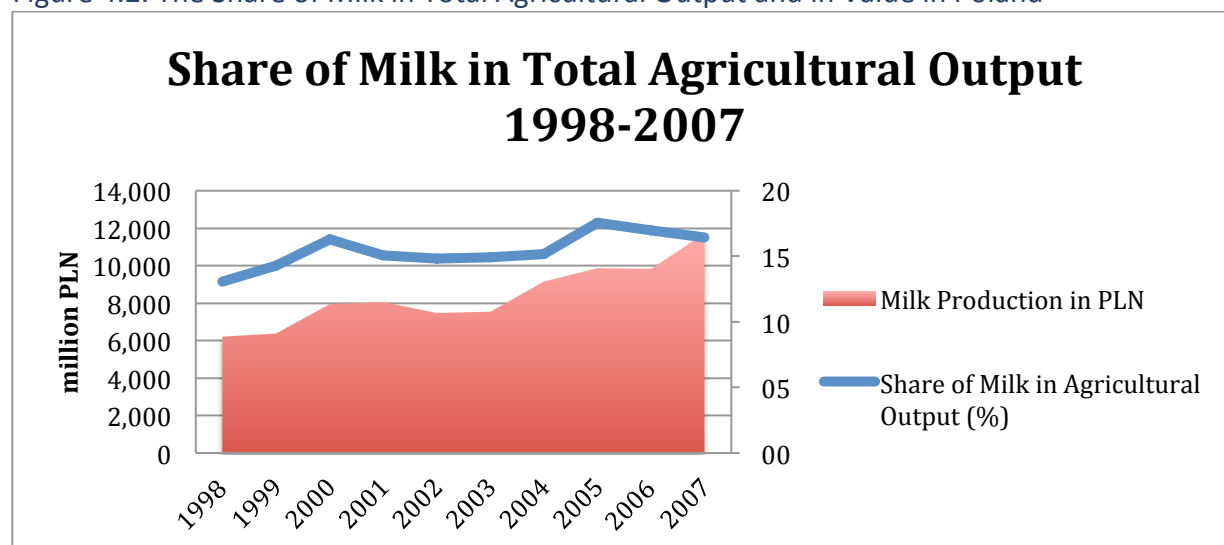
The Polish and Hungarian food retail sectors are very different: the Hungarian sector is highly concentrated and MNC specializing in hyper- and supermarket formats such as Tesco, and German discount chains with high profitability compete with a network of domestic retailers that specialize in smaller proximity stores operating with lower profitability (see chapter 3). In Poland by contrast, the retail segment is substantially less concentrated with a CR5 ratio of 20% - compared with 70% in Hungary (Bakucs, Falkowski, & Fertő, 2012) – which might in turn explain, why, MNC retailers have not become as central to the sector's restructuring as in Hungary.

Value-Added Upgrading in Production

What is striking in the Polish case is the discrepancy between a relatively stable position of the milk and dairy sector within the national agricultural and agri-food economy, while the revenues generated by the sector show tremendous improvement, particularly accelerating after EU accession in 2004: for instance, while the share of milk in total agricultural output modestly rose from 13% to 16% between 1998 and 2007, revenues almost doubled in the same decade from 6 to 11 billion PLN (see Figure 4.2).

⁷⁴ Naturally, this has to be put in perspective with the later re-domestication of the Hungarian processing segment as discussed in the previous chapter, where even after MNC exit, the two dominant domestically owned processors control today 50% of the market.

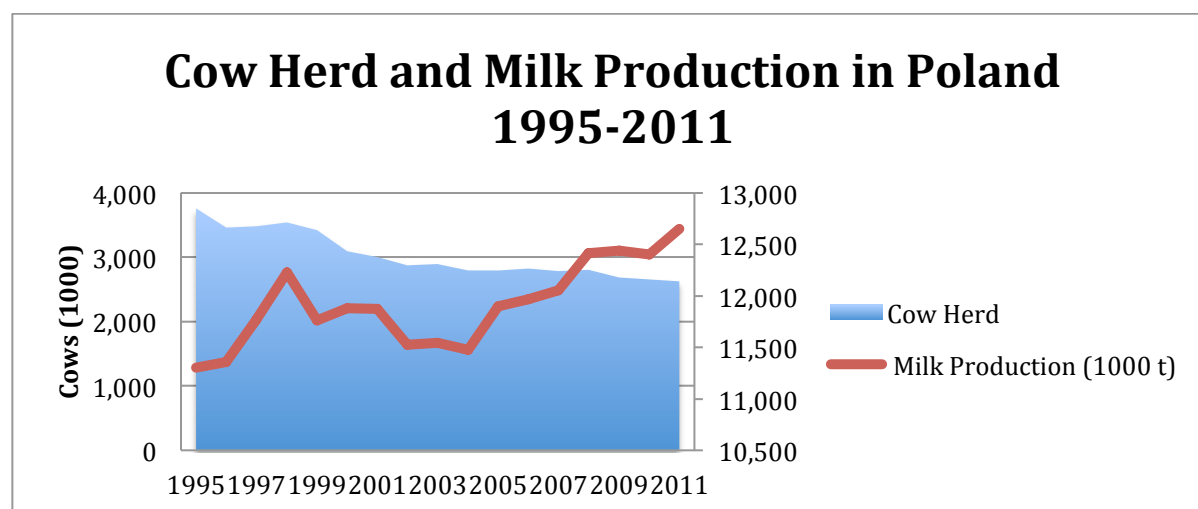
Figure 4.2. The Share of Milk in Total Agricultural Output and in Value in Poland



Source: Polish Statistical Office (GUS)

When contrasting herd size with milk production over the past 25 years, one observes a gradual, steady decrease in herd size – which is unsurprising given the challenges inherent in adapting a centrally coordinated Socialist economy to free market conditions: livestock and output levels plummeted in the aftermath of 1989 throughout the CEE region in all agri-food sectors (and more generally, virtually all industries). In fact the Polish decrease, while substantial, was not the most dramatic or sudden by CEE standards: herd size dropped from close to 4 million heads in 1995 to 2,6 million in 2011. Output levels have increased steadily on the other hand: from 11,5 to 12,6 million tons over the same period. The first conclusion one can draw is that gains in productivity should account for the difference between a diminishing herd and rising output levels.

Figure 4.3. Cow Herd and Milk Production in Poland 1995-2011



Source: AKI, GUS

That assumption is confirmed in all available datasets: The Polish dairy sector did in effect display steady gains in productivity throughout the transition period of the 1990s and 2000s. In the dairy sector, the generic indicator of productivity is the milk yield (measured in liters/cow/year) – which increased by 70% in 23 years.

Table 4.2. Polish milk yields 1990-2011

	1990	1995	2000	2005	2007	2011	2013
Milk Yields	3246	3255	3778	4271	4400	5001	5532

Source: based on AKI, FAOSTAT

More specific data but also less prone to long-term analysis confirms these productivity gains at the sector level: a study by Szajner based on unpublished data by the Polish National Bureau of Statistics (GUS) thus examines labor productivity per employee in volume and in value between 2003 and 2007. Szajner finds an increase from 174 tons per employee in 2003 to 230 tons by 2007 and a corresponding increase from 61 100 euros per employee to 147 600 euros over the same period. Furthermore, he equally established that gross value added per employee tripled from 23 700 euros in 2003 to 63 000 euros in 2007 (Szajner, 2009).

At first sight, these improvements might seem impressive, but in comparison with EU15 averages and even regional CEE competitors, while notable, they are more measured: relative gains in productivity were also substantially stronger in Hungary than in Poland as shown below in Table 4.3. below.

Table 4.3. Variation of Milk Yields in CEE 2000-2010

Milk Yield Variation 2010/2000	
Czech Republic	+21,1%
Hungary	+36,3%
Poland	+19,3%
Slovakia	+6,9%

Source: FAOSTAT

In other words, the defining trends at production level in Poland reflect the same challenges of post-Communist transition as in Hungary and CEE by large- what differentiates Poland is actually the relative stability of the sector in transition, marked by lesser gains in productivity but also a less brutal drop in herd size and a steady, gradual increase in volumes produced.

However, the radically different pathway of Polish dairy compared with the Hungarian experience of a progressive collapse in competitiveness becomes apparent when examining the value-added content of its product specialization in the production segment: contrary to Hungary, Poland shows a clear trajectory of value-added upgrading, which equally translates in the soaring competitiveness and profitability of its exports.

Table 4.4. Production of Dairy Products by Main Categories 1990-2011 ('000 tons)

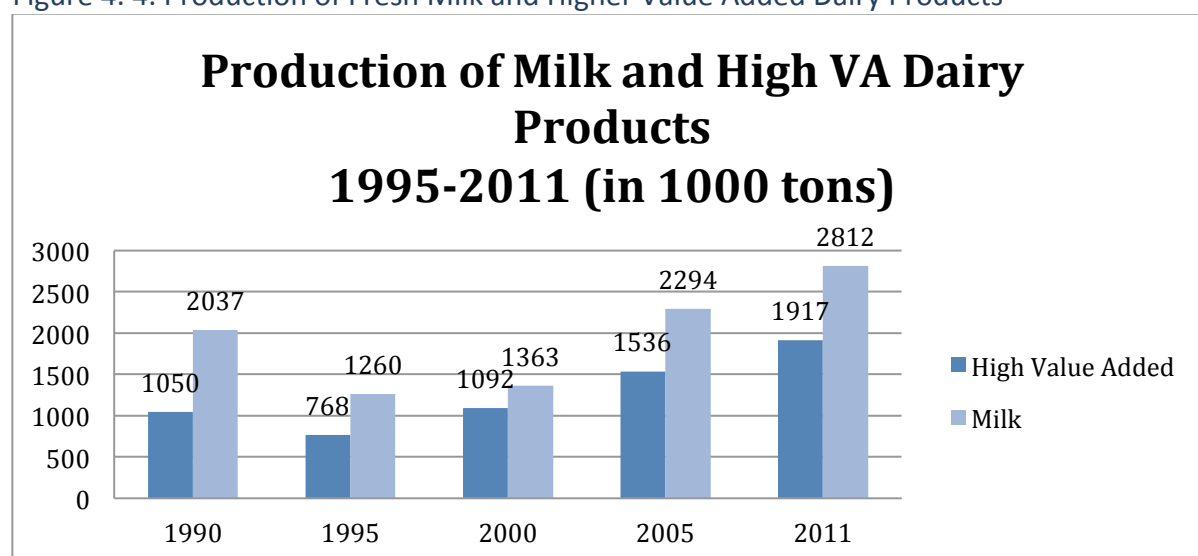
	1990	1995	2000	2005	2011
Butter	290	123	139	179	171
Hard Cheese	130	122	148	239	285
Curd	295	198	262	295	382
Milk Powder	226	169	158	192	148
Yoghurt, Drinks		150	345	510	739
Milk	2037	1260	1363	2294	2812
Cream	335	175	198	313	340

Source based on Szajner (2009), GUS, (Szajner & Vőneki, 2014a), (Szajner & Vőneki, 2014b)

Polish dairy processors (domestically owned cooperatives in the vast majority) strengthened their market position in two specific segments: fresh milk and higher value added processed goods such as cheese, yoghurt and curd on the one hand, and fresh milk on the other. Production initially suffered an abrupt drop following 1989: the production of fresh milk was halved in only five years between 1990 and 1995. The early challenges in restructuring were overwhelming: domestic demand and consumption of dairy products faltered as inflation rates soared in the aftermath of the Balcerowicz reforms, traditional Socialist export markets were themselves depressed, the Socialist subsidy system of dairy production was replaced with new, experimental forms of support, the vertical coordination of the sector by the state collapsed, while new legislation transformed the legal status and ownership structure in dairy cooperatives. In spite of these challenges, the sector adapted and consolidated surprisingly quickly: the rebound in production levels was already apparent by 1995. In most product categories, the 1990 output levels were matched with by 2000. Notably, EU accession in 2004 had dramatically different impacts than in the Hungarian sector where it reflects a critical juncture after which production and exports rapidly collapse. In Poland on the contrary, EU accession didn't hinder the post-Socialist rebound in outputs: by 2011, quantities of fresh milk were 40% superior to 1990 levels. In other words, at the production level, one can see an uninterrupted trend of expansion since 1995. Furthermore, the two decades following the transition were not only marked by an increase in output volumes but also by a rapid expansion in higher value added product types in particular. As shown in Figure 4.4, value-added upgrading is apparent

throughout the 1990s and 2000s. By 2011, higher value added products represented twice and a half the volume of the low point experienced in 1995.

Figure 4. 4. Production of Fresh Milk and Higher Value Added Dairy Products



Source: own calculations based on GUS, AKI

It is important to stress that the Polish sector's success, especially in the two key product categories of fresh milk and higher value added goods is particularly remarkable considering the serious structural problems faced by the Polish sector in the early 1990s: At the beginning of the transition process, it was more than dubious whether Polish dairy could adapt and even survive in a free market environment. As discussed further below, the structural problems hindering adaptation seemed overwhelming: a highly fragmented ownership structure, outdated technologies, poor genetic stock, the inability to comply with basic food safety standards, extremely low productivity, a lack of capital necessary for modernization – all coupled with the prospect of new, Western competitors entering the market, against whom Polish cooperatives were utterly uncompetitive. In light of these fundamental problems, Polish dairy should have rapidly succumbed to the stress of free market competition as many other industrial sectors in post-Communist CEE that were deemed outdated and uncompetitive: indeed, our respondents also confirmed that both public authorities and farmers feared a general collapse of the sector even on the eve of EU accession⁷⁵.

⁷⁵ Interview National Union of Dairy Cooperatives (KZSM), 11/02/2014

Upgrading in trade and climbing up the value chain in the face of important challenges

The financial viability of the sector was severely threatened by the bottleneck effect experienced both in domestic demand and on export markets. In light of the two key products of fresh milk, and higher value added processed goods, the marketing and export opportunities were extremely bleak in the early 1990s. Different types of challenges characterized these product segments, both at the production and the trade levels: The key challenge for exporting fresh milk lay with a lack of capacities for implementing modern food safety standards, specifically the ISO 9000 and HACCP labels. Sanitary and phytosanitary standards (SPS) while they might be necessary to sustain trust, might also function as non-tariff trade barriers in mature markets such as the EU, and Poland faced tremendous challenges in implementing these norms. This also posed a geographic challenge since due to its location, Poland has two natural export markets: Western Europe and Russia. Given the dramatic economic collapse of post-Communist Russia and CIS after 1991, the traditional Eastern export market was depressed in the early 1990s, while the Western European market remained simply closed to Polish exports until Polish producers and processors proved fully able to enforce SPS standards. The implementation and enforcement of food safety standards is not only an economic problem rooted in a lack of capital (although investments are equally necessary for ensuring higher quality products) but also an organizational, institutional and regulatory problem rooted in the capacity of public and private actors to regulate and monitor the sector, which requires stable vertical coordination in the supply chain. Until Poland complied with European food safety standards, it could only export limited quantities to ad hoc partners, often geographically distant – with transportation costs cancelling out much of the sector's competitive advantage in prices. It was only after EU accession in 2004, that Poland's export destinations decidedly shifted westwards and stabilized inside the EU's Common Market as shown in Table 4.5.

Table 4.5. Poland's Primary Dairy Trade Partners 1995-2007

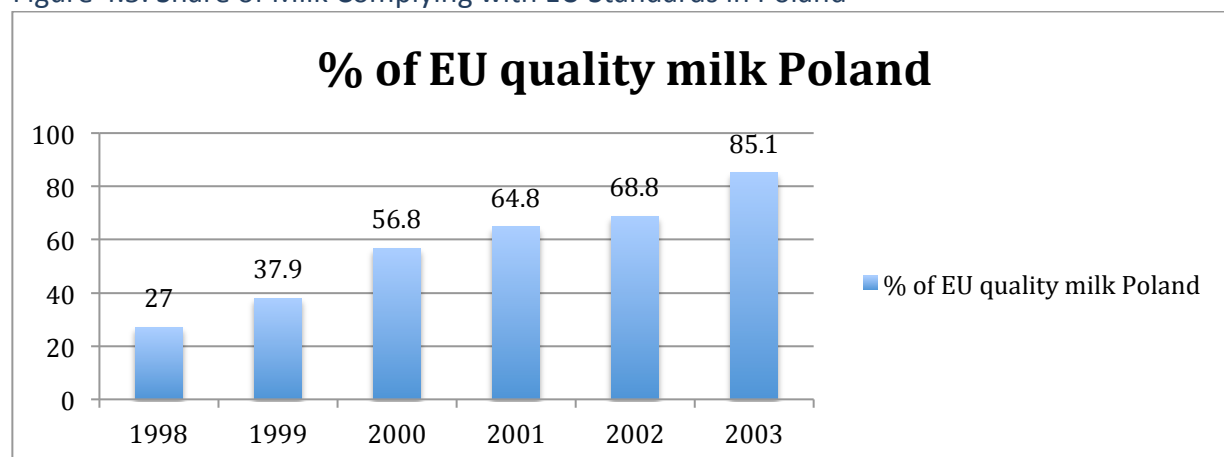
1995		2000		2007	
Exports in %					
Netherlands	32,2	Mexico	16,4	Germany	23,8
Russia	11,2	Algeria	14,1	Netherlands	8,4
USA	10,9	Netherlands	7,2	Czech Rep.	7,3
Germany	8,4	USA	7	Italy	6,8
Vietnam	7,3	Czech Rep.	6,2	Algeria	5,5

Source: Szajner (2009) p.15

The problem of food safety monitoring and standard compliance was so acute – in particular regard to fresh milk – that Poland was given a two-year extension period after the 2004 accession for reaching full compliance – during which time Polish exports to the EU continued to be restricted: While the Commission extended the deadline for regulatory compliance until after accession, Poland was also issued an export ban in dairy products to the EU market on December 1, 1997 because of unsatisfactory milk quality (Weyerbrock & Xia, 2000). As a result, Polish dairy exports to the EU were substantially constrained until 2006. A strong suspicion among Polish producers is that EU15 countries used SPS standard compliance strategically for holding back Polish milk from their own markets due to its price competitiveness⁷⁶ - it remains that the overall quality of Polish fresh milk likely dragged objectively below EU standards throughout the 1990s: according to Polish processors' own organization *Izba Mleka*, two years before EU accession, a third of Polish milk production was still not in compliance with EU standards (Figure 4.5).

⁷⁶ Interview with Marcin Hydzik, Head of the Polish Association of Milk Processors (ZPPM)

Figure 4.5. Share of Milk Complying with EU Standards in Poland



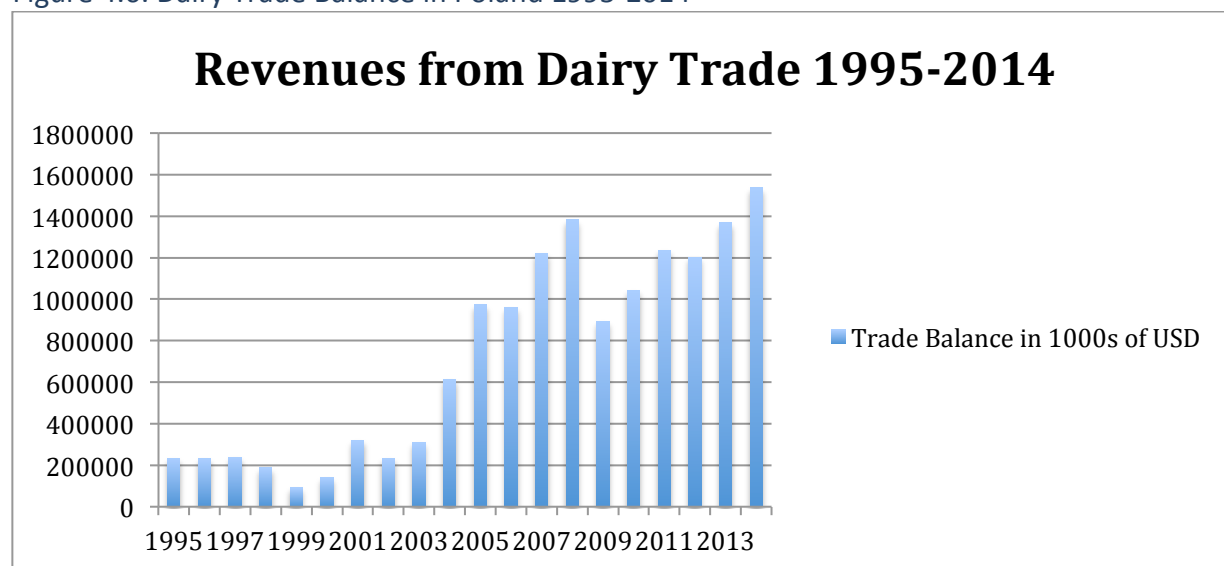
Source: Izba Mleka

The second product type where the Polish sector proved highly successful was in the higher value added segment of processed goods: for this category of products, the challenge lay not only with the adoption of stringent SPS standards but with the volume of capital and investments necessary for upgrading existing machinery and related services such as packaging, marketing etc. Technological modernization necessitated investments, which a heavily indebted Polish state, struggling with soaring levels of inflation and collapsing domestic purchasing power could only finance with foreign capital. However, unlike Hungary, the primary source of investments didn't come from FDI and MNCs through large scale privatization, but from foreign aid and technical assistance providers – chief of which the World Bank and the European Community (later EU), as discussed in a subsequent section of this chapter. Nevertheless, the success of competitive upgrading in the value chain was far from evident or mechanical: we argue that more than a success of externally steered upgrading, it most fundamentally reflects the capacity of Polish public authorities to establish an institutional framework for the regulation, technical assistance and financing of the dairy sector. In other words, while the primary source of capital came from transnational actors, it was efficient in competitive upgrading only to the extent that the state, ministries and public administrations, regulatory agencies and scientific inspectorates proved capable of securing and coordinating a steady supply of foreign capital and build complementarities between programs often financed from different sources (bilateral aid, structural adjustment loans and the EU's pre-accession funds) as discussed in greater detail further below.

The Polish sector embarked on transitioning to a market economy with severe disadvantages, and yet, the competitiveness and trade integration of Polish dairy products reflects the same continuous upgrading trend as exemplified at production level. Even in the immediate aftermath of regime change when it experienced its most severe setbacks, Poland never became a net importer of milk and dairy products. Examining the trade balance of the sector it becomes clear that EU accession in 2004 represented a critical juncture with an instantaneous surge in revenues from exports. Throughout the pre-accession phase, Polish dairies were concerned that EU integration might turn the domestic market into a net importer due to stronger competitiveness on the part of EU15 dairies. It has to be reminded that these fears seemed rational at the time: in the Hungarian case, EU accession in effect led to a collapsing trade balance and the Polish trend seemed equally preoccupying immediately prior to EU integration as shown in Figure 4.6. The year 1999 marked the absolute low for Polish dairy trade with a positive balance of 91 million USD, but even in 2003, only a year before entering the EU market, trade in the sector only generated a surplus of 308 million USD – which pales in comparison with the 1,4 billion USD of 2008 (a year before the financial crisis hit consumer markets in the EU). This initial bottleneck on Polish dairy exports was a direct consequence of the 1997 export ban imposed by the EU as explained above.

After 2004 however, the explosion of revenues from trade in dairy is all the more surprising that, in spite of an equally positive trend in production capacities, increase in milk production augmented substantially more modestly: Poland produced 11,4 million tons of milk in 2004, compared with 12,6 million tons in 2011. In the same period however, trade balance doubled from a surplus of 613 million USD to 1,2 billion USD (Figure 4.6.). The discrepancy between the two trends shows that the soaring profitability of the sector didn't so much reflect a surge in production capacities but is better explained by the higher profitability and improving value added competitiveness of Polish dairy products on export markets. This lends some credit to the suspicion of Polish farmers and processors who believe that their exports to the EU had been artificially delayed: EU15 dairies might have gauged Polish competitiveness better than Polish actors themselves, who feared a competitive collapse.

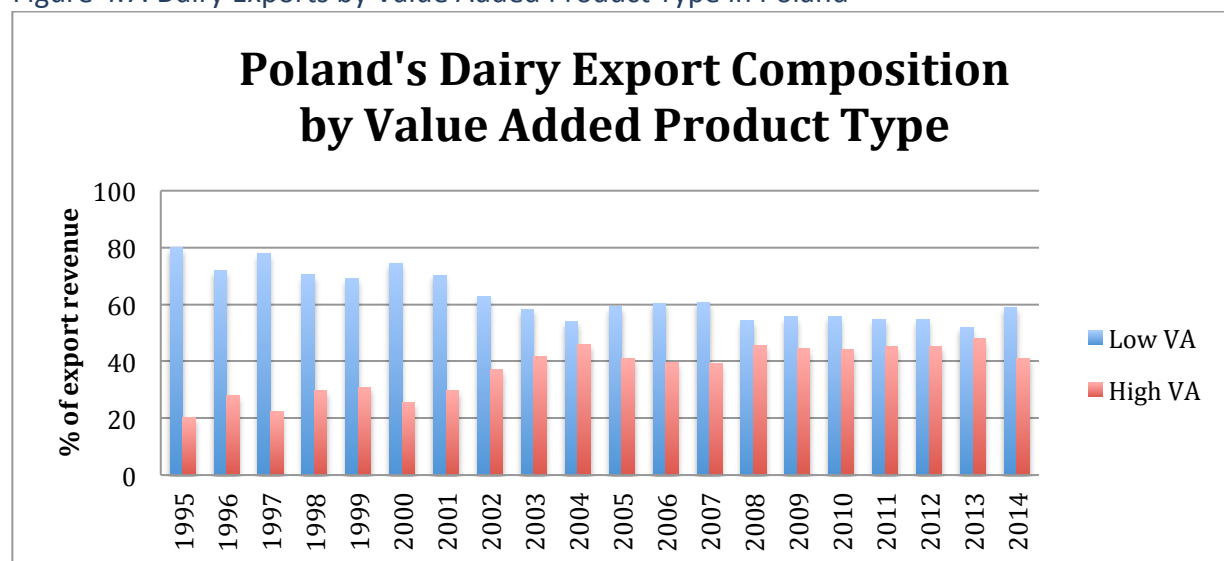
Figure 4.6. Dairy Trade Balance in Poland 1995-2014



Source: UNCTAD

We have already noted the positive value-added upgrading characterizing the production segment throughout the 1990s where higher value-added products occupied an increasing share in total production: in light of this, it is also interesting to observe the value added composition of exports and the share of key product categories in the total revenues generated through trade. As shown in Figure 4.7, the value-added upgrading trajectory in the production segment also translated in the composition of Polish dairy exports: while 80% of export revenues were generated from low value added products in 1995, by 2013, the share of low and high value added products were virtually equal.

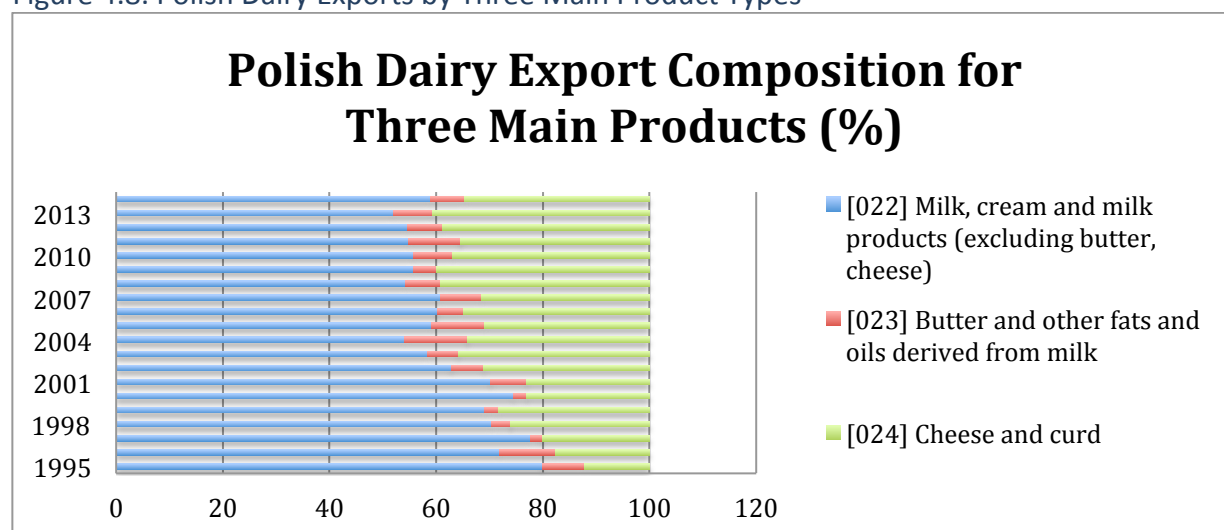
Figure 4.7. Dairy Exports by Value Added Product Type in Poland



Source: own calculations based on UNCTAD

In other words, Poland didn't flood the EU market only with fresh milk and lower quality products but its success in the Common Market is also explained by an increasing specialization in more complex processed goods, drawing more revenue, and that are appreciated by Western European customers: for instance cheese only represented 12% of exports in 1995 but its relative share tripled to 35% by 2014 (Figure 4.8.).

Figure 4.8. Polish Dairy Exports by Three Main Product Types



Source: own calculations based on UNCTAD

These figures indicate a close correlation between the process of value-added upgrading that occurred gradually at the production level throughout the 1990s and 2000s and increasingly profitable revenues generated through trade, which ultimately skyrocketed after EU accession. However it is crucial to point out that value added upgrading in production was not primarily steered by export markets: Poland's success as one of the biggest EU dairy exporters only occurred relatively recently after all restrictions on its access to EU15 markets were lifted after 2006. In other words, it was not Poland's integration into transnational markets (specifically the EU) that steered value added upgrading in the production segment (a recurrent argument in the World Systems Analysis literature, which derives an economy's specialization from its relative place within transnational trade flows and supply chains – but rather, the gains from trade that Poland went on to realize in open markets are better explained by the continuous efforts invested in upgrading the sector throughout the 1990s when the sector was relatively more protected. Trade competitiveness was an outcome of production upgrading, not the opposite. In that sense, the pathway of Polish dairy mirrors the arguments of Ha-Joon Chang on the competitive upgrading myth of free markets (H.-J. Chang, 2008): while Polish dairies' exports were severely constrained (most notably because of poor milk quality and a lack of compliance with EU food safety standards), this decade also let the Polish state use tariffs, subsidies and support mechanisms, which would not have been possible inside the EU. Ultimately, the explosion in export competitiveness realized after 2004 is a direct result of upgrading realized throughout the 1990s: as such, this decade functionally played the role of infant industry nurturing in Poland.

Conclusion on indicators:

The developmental trajectory of the Polish dairy sector displays an entirely different model compared with the Hungarian case: the distinctive feature is a surprising and robust improvement of the sector's overall competitiveness, which translates in a very strong position on export markets. The second distinctive feature is that competitive upgrading was not realized at the expense of domestic actors: on the contrary, the sector continues to be controlled by domestically owned firms in the range of 80% (Seremak-Bulge, 2005).

More specifically, these are dairy cooperatives inherited from the Socialist era, where farmer-producers own processing facilities: thus, the production and processing segments of the supply chain are firmly integrated within these firms. This institutional structure is fundamentally different from the organization of the Hungarian sector where production and processing have been disintegrated - split between a handful of processing firms on the one hand and a host of producers ranging from smallholders to vast estates on the other. This is not to say that the social costs of post-Socialist restructuring were easy to swallow in Poland: the majority of the smallest producers have been clearly forced out of the market. However, from the vantage point of domestic actors, the Polish trajectory nonetheless represents a more inclusive trajectory, where gradual concentration did not result in the outright marginalization of all domestic actors in the supply chain – as it happened in Hungary.

The Polish sector's competitive success was far from predictable: the structural problems of the sector (low productivity, low quality, low capitalization – coupled with an extraordinarily fragmented land ownership structure) could have easily explained a competitive collapse in the 1990s, or at latest after EU accession. As a matter of fact, even as late as 2004, some argued that the failure of Poland's food processing sectors was not only predictable but over-determined: *"The average size of a Polish farm is about 7 hectares (approximately 17 acres), less than half the EU average of 16 hectares. The state-socialist legacy is also evident in quality produced. Poland's farmers and food-processing industry often do not reach the quality level of imports, which Poles can now afford and easily obtain. Uncompetitive farms will not survive long inside the Union; this means that many farmers will join the sizable ranks of the unemployed in Polish cities, where unemployment is already higher than in most European countries (nearly 20 percent in 2004). The prospects of these impoverished sectors are likely to remain dim."* (Seleny, 2006, p.265) It is clear in retrospect that this gloom was unwarranted as Polish dairy became on the contrary one of the very few genuine industrial success stories of the Eastern Enlargement from a developmental perspective. To the extent that economic upgrading is as much conditional on financial and human capital as on stable and inclusive property right regimes as discussed in the second chapter – it is clear that Polish actors did things very differently from their Hungarian colleagues: it is thus

logical to assume that the patent divergence in developmental outcomes rested on a different mode of transnationalization where access to capital and institutional reforms were solved differently – and from a developmental perspective, more efficiently.

Part 2. Restructuring the sector

Before examining the role and strategies of public and private actors in restructuring the sector, it is important to highlight how long-term institutional legacies affected the opportunity structure for domestic agency. The fundamental challenges of Poland and Hungary both at the sector- and the macroeconomic level were essentially similar in 1989: state budgets incapacitated by punitive levels of foreign debt, and an agri-food sector lacking capital, technology and knowledge that nonetheless necessitated immediate investments for surviving under free market conditions. Different modes of transnationalization in the two countries constituted different policy answers to the same problems circumscribed by different institutional legacies, which delimited a different policy space for agency.

Polish dairy cooperatives before Independence and under State-Socialism

The history of Poland's dairy sector in the 19th and 20th century was characterized by the central role of agricultural production cooperatives, yet the emergence of the cooperative movement was somewhat distinct from comparable experiences in Western Europe or even in CEE: throughout the 19th century, Poland was entirely occupied – what is more, divided - between two competing regional powers, namely Russia in the East and Prussia in the West (later Austria in the South). These conservative, absolutist monarchies used the pretext of Jacobin inclinations in the Polish-Lithuanian Commonwealth to militarily occupy and divide Poland in three consecutive partitions, which in spite of armed resistance movements, eventually split the country in two by 1795: Polish independence and statehood was delayed until the 20th century. The emergence of credit cooperatives, agricultural producer- and marketing cooperatives in the 19th century were answers to increasing market pressure from imports just as in industrialized countries: agricultural and dairy cooperatives represented a similar institutional answer to competitive challenges even in the US (Schneiberg, 2011). But in

occupied Poland, cooperatives were just as much tied to an anti-colonial resistance movement against German and Russian gentries (Bartkowski, 2013). The Polish experience in dairy cooperative development resembled the Danish pathway (a pioneer of agricultural cooperatives), a country equally colonized by Germany in the 19th century. In both cases, cooperatives built social capital among farmers: in both cases also, dairy cooperatives were generally not set up by enlightened agricultural landlords but were genuine grassroots organizations established by farmers (Chloupkova, Svendsen, & Svendsen, 2003; Chlupkova, 2002). In Poland, the establishment of agricultural cooperatives preceded self-determination: cooperatives thus functioned as the first building blocks of a nation-building project even before statehood could be secured⁷⁷. This historical particularity had long-term consequences: the symbolic charge of cooperatives as part and parcel of nation building and the social capital (trust) that these organizations helped accumulate created considerable resources for farmers to resist forceful attempts by the state to change existing property rights institutions both under state Socialism and in the wake of 1989 restructuring.

As a sign of their resilience, dairy cooperatives were rapidly re-established after the war in 1947, yet the consolidation of a Communist government in 1948 represented a new challenge to the cooperative model. In the period between full Communist take-over in 1948 to de-Stalinization in 1956 – marked by Gomulka’s return to power – the new leadership embarked on a policy of forceful Sovietization. In agriculture, this meant collectivization following the Soviet model, which accepted two legitimate forms of ownership: *kolkhozes* (collective cooperative ownership) and *sovkhozes* (state ownership) – or in the Polish context, Farmers’ Cooperative Teams (RZS) and State Agricultural Farms (PGR). Unlike other food sectors where linkages between producers and processors were looser, the fact that the dairy sector had been structured around cooperatives already in the pre-Socialist era could have fuelled hopes that the transition would be less disruptive: however, the sector’s organization was fundamentally challenged in 1951 when the state dissolved dairy cooperatives and nationalized the entire sector (World_Bank, 1991). Ultimately however, this approach failed due to passive and active forms of resistance among the peasantry. This was not a specificity of

⁷⁷ Ironically, Ukrainians living under Polish rule in Galicia after 1918 imitated the same strategy: agricultural cooperatives, notably dairy producer cooperatives - were bastions of Western Ukrainian nationalism directed against Polish occupiers (Sorokowski, 1991).

the dairy sector: instead, the regime's entire agricultural collectivization agenda collapsed. The failure of agricultural collectivization in Poland constituted a singularity, which set Poland apart from other Socialist regimes: the *nomenklatura* was forced into retreat by a peasantry that threatened to destabilize the entire regime (Jarosz). In 1956, the state officially gave in and backtracked: Gomulka's return to power put an end to the collectivization of agriculture. In other sectors, this meant that the regime accepted the dissolution of cooperatives set up under physical threat – in the dairy sector however, it led to a return from state ownership to the cooperative format: in 1958, the dairy sector was de-nationalized and cooperatives were reestablished (World_Bank, 1991). Furthermore a national-level Union of Dairy Cooperatives was set up for the first time. In 1975, the state tried again to transfer dairy cooperatives under another umbrella organization, the Central Agricultural Union of Peasant Self-Aid, however this proved yet another failure and in 1981, their autonomy as well as the national Union were revived (World_Bank, 1991). From our perspective, these processes enshrined a fundamental difference compared with Hungary: the Socialist state did not legally own productive assets directly in the dairy sector as these belonged to cooperatives. Under state Socialism, this wasn't consequential as cooperatives hardly enjoyed any effective autonomy, after 1989 however, differences between “effective” public ownership and cooperative property set different constraints on what the state could single-handedly do with collective assets during privatization.

Debt and privatization in Poland

Different experiences of collectivization in Poland and in Hungary in the 1940s and 50s proved consequential in the two countries' management of agricultural privatization after 1989: In the previous chapter, we detailed that the Hungarian state's disintegrative role in the dairy sector was a consequence of its peculiar privatization agenda: the privatization of processing plants was largely hijacked by the Ministry of Finance in Hungary, which had a clear objective – to raise as much foreign capital as quickly as possible for financing a foreign debt service, which suffocated the state budget. In that context, the dairy processing plants owned by the national Dairy Trust fell in the first group of assets, which the state could sell swiftly, without substantial opposition from farmers. All other considerations regarding the sector's long-term competitive prospects

became secondary: the negative effect of severing ties between undercapitalized farmers-producers and a processing sector transferred to multinational companies proved marginal to stabilizing the state budget. In parallel, the re-privatization of land became a politicized issue with a reparatory function: a consequence of re-privatization was the incapacitation of producer cooperatives, which lost a substantial share of the land they had owned. In Poland, the question of land privatization was substantially less dramatic: one reason was that state farms only accounted for 20% of agricultural land (Table 4.6). Furthermore, due to the regime's halted collectivization agenda in the wake of Gomulka's return to power in 1956, the regime had also tolerated the dissolution of cooperatives that had been forcibly set up between 1944 and 1956. As a result, state property and cooperative ownership combined only ever represented a quarter of total agricultural land, while three quarters were privately owned. By comparison, these proportions were inverted in Socialist Hungary where private property only stood at 15%.

Table 4.6. Land Tenure by Ownership Before Post-Socialist Reforms in Poland and Hungary

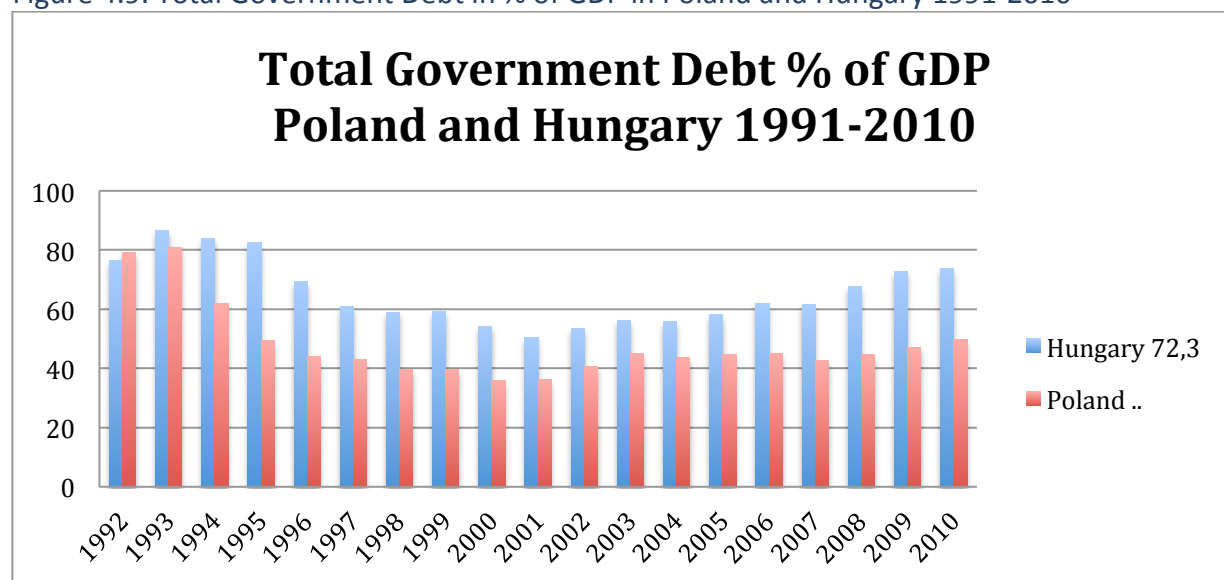
	Hungary	Poland
State	14	20
Cooperative	70	3-5
Private	15	75-77

Source: (World_Bank, 1995)

The de-collectivization of land was therefore less painful in Poland where collective- and state ownership had remained relatively marginal. A further difference with Hungary was that land privatization in Poland was equally divorced from the highly politicized and contentious issue of reparatory justice: farmers didn't have to be compensated since they hadn't been expropriated by the state in the first place. The only potential beneficiaries of reparatory justice would have been the big landowners of *latifundia*, which had been divided in 1944, creating the post-war class of Polish small peasantry: however, no political party advocated a return to pre-war *latifundia* after 1989. Briefly put, in Poland the privatization of land did not jeopardize the pre-existing distribution of ownership rights, nor did it pose a problem for the viability of cooperatives (per se) as it did in Hungary.

Unlike in Hungary, the debt problem didn't determine privatization strategies in the dairy sector. In Poland, the question of debt was equally pressing after 1989 for similar reasons as in Hungary and other Socialist economies, where it had played an increasingly central role as a buffer for state budgets after the 1960s. The level of indebtedness in proportion to GDP was also very similar to Hungary.

Figure 4.9. Total Government Debt in % of GDP in Poland and Hungary 1991-2010



Source: OECD

Yet, the organization of the state at the sector level – differences in property right regimes structuring the sector under Socialism in particular – prevented a Hungarian privatization model: unlike in Hungary where processing plants belonged to the state due to a fuller collectivization in the 1950s, the resilience of Polish dairy cooperatives' independence ensured that cooperative membership controlled all assets – processing plants included. In Hungary, the disjunction between production and processing allowed for the state to implement two differentiated privatization strategies for the two segments of the supply chain (both catastrophic). In Poland however, the state couldn't sell cooperative assets for stabilizing the state budget without first expropriating two million dairy farmers organized in the Central Union of Dairy Cooperatives. The organizational resources afforded by a thick institutionalization of regional and national dairy cooperative unions, and the extant property right regime governing the sector – whereby dairy cooperatives were owners of their productive assets – certainly represented a safety net for dairy producers amid chaotic macroeconomic changes. It

also gave substantially better organizational capacities for dairy producers to play an active role in shaping restructuring – unlike in Hungary. The fact that the state was not the primary owner of productive assets also helped avoiding a “Hungarian scenario”. Finally, the pressure of foreign debt further eased as Poland, contrary to Hungary, managed to negotiate two consecutive debt-restructuring programs with its foreign creditors in 1991 and 1994 (Bjork, 1995).

However, the survival of Polish producer cooperatives was not pre-determined either: The legal status of cooperatives needed to be amended. The first discussions about privatization options took place in 1988 at a Conference held in Warsaw by the Central School of Planning and Statistics, while a Plenipotentiary for Ownership Transformation was set up by the Ministry of Finance in 1989 (Gomulka & Jasinski, 1994). However, discussions centered mainly on the question of large public firms and conglomerates: agri-food cooperatives constituted a somewhat different challenge. In this context, new legislative amendments to the 1982 Cooperative Law were passed in 1990 and 1991. The severely negative component of these reforms was the dissolution of all cooperative unions – national, regional as well as sector-level unions were disbanded: the Central Union of Dairy Cooperatives fell prey to this agenda along with regional dairy cooperative unions (Kowalak, 1993). The law stipulated that new cooperative unions could only be re-established after 1991: the state didn’t so much want to destroy the cooperative union system as to remold cooperatives in a new, democratic format. Still, the 1991 law stipulated that enterprises owned by cooperative unions had a choice between either transforming into workers’ cooperatives or into stock companies, while the Ministry of Finance sent liquidators to supervise the process (World_Bank, 1991). The aim of the Solidarity government led by Mazowiecki was to encourage a dual process: First, democratization at the cooperative level - in order to eliminate the grip of local Communist elites on cooperatives. New elections had to be held within two months at the level of primary cooperatives: it has to be noted here that in light of the sector’s later pathway, this attempt by the state at replacing management largely failed as trustworthy leaders (or those commanding sufficient social capital) were systematically re-elected. In fact, the top management remained largely stable at the head of the biggest dairy cooperatives well into the 2000s. The second aim was the transformation of cooperatives into “real” capitalist companies: in this field, competing rationalities

prevented swift reforms. On the one hand, there existed domestic and external pressures for disbanding cooperatives altogether: Balcerowicz' shock therapy agenda would have been sympathetic to re-privatizing cooperatives and creating limited liability companies on their remains. As discussed later in this chapter, certain departments at the World Bank - a major creditor of Poland - also shared these views⁷⁸. In light of resistance to this pathway both inside the Solidarity leadership and among co-operators themselves, the state eventually passed a Law on Cooperatives in 1992 – in tandem with cooperative leaders, who participated in its elaboration - which declared cooperative ownership a capitalist-compatible, legitimate form of private property: the 1992 Law on Cooperatives considered cooperatives a form of private property based on that of their individual members (FAO, 1994). In 1994, it seemed still possible that the state would implement a new wave of reforms regarding the legal status of cooperatives (Jasinski, 1996, p.238). By then however, dairy cooperatives had managed to strengthen their position, which effectively prevented any further attempt at re-privatization: while the National Union of Dairy Cooperatives had been disbanded in 1990, the membership didn't accept this situation and sought continuity: the 1990 Law on Cooperatives had also allowed for the establishment of new, ("democratic") cooperative unions after 1991. In effect, the national Union was re-created as such in 1992. Overall, the state's attempt at "purging" both primary cooperatives and national cooperative unions from "suspicious elements" proved a failure: in both cases, cooperative members clearly preferred continuity both in organizational structures as in leadership (World_Bank, 1991). The new shape of the dairy cooperative sector after 1992 was hardly different from the Socialist period – in spite of a change in legal status, new elections, and the creation of a "new" cooperative union.

Part 3. Re-Governing the Market

Although historical-institutional legacies can explain why the Polish pathway didn't replicate the Hungarian sector's integrationist strategy, they don't offer sufficient explanations as to how the Polish sector managed to improve both its competitive

⁷⁸ The position of the World Bank on cooperative privatization is complex: Bruszt and Langbein (2014) found evidence that other departments within the Bank advised the Polish government precisely against the dangers of cooperative reprivatization. The Bank was seemingly just as split on the question as the Polish state itself.

position on transnational markets while simultaneously protecting the market shares of domestic actors. In other words, while the state didn't forcibly disintegrate the dairy supply chains, it still had to find new solutions for satisfying the investment needs of domestic dairy cooperatives: short of a stable access to financial capital and technology, Polish dairies would have quickly been eliminated. Unlike the Hungarian integrationist plan, which primarily relied on MNCs as sources of capital, technology and potential spillovers to domestic firms (which failed to materialize), in Poland the state played a crucial role in solving access to capital. In that regard, the Polish pathway reads as an illustration of a co-evolutionary developmental alliance between the state and domestic dairies, where upgrading was ultimately co-produced. While in Hungary the role of the state in re-governing the market lay in the use of protectionist regulatory instruments (in the 2000s –after a period of relative *laissez-faire*), the Polish state by contrast played a central role in pooling foreign capital from different sources and implementing a lengthy and complex developmental agenda in coordination with domestic cooperatives. This effort was not only financially costly, but it also tested the state's administrative capacities as it entailed the creation of public agencies enabling coordination among public and private actors as well as new forms of public interventionism at the sector level. Furthermore, as the Polish state's financial stability was equally weak – in spite of foreign debt restructuring – and it was clear that it didn't have the necessary resources for financing this roadmap alone. In this context, the state used different sources of foreign capital: bilateral aid programs contracted with individual EU15 governments, loans from IFIs such as the IMF and the World Bank, and increasingly after the mid-1990s when EU accession became a realistic prospect – pre-accession funds. Polish public actors had to learn coordinating the resources pooled from multiple bodies and integrating them into coherent developmental plans translated into operational programs and projects in conjunction with domestic beneficiaries. Just as importantly, they had to learn navigating the explicit and implicit priorities of donors themselves for advancing their own objectives. In spite of inherent challenges and the cost of material and immaterial investment, the Polish strategy paid off: Polish domestic actors in the dairy sector not only survived post-Communist transition and EU accession but they became one of the primary beneficiaries of market integration – once their competitiveness had been strengthened enough to “withstand competitive pressure” in open markets.

The state and cooperatives: the co-evolution of public and private capacities

The emerging developmental coalition in Poland relied on two actors. On the one hand, the resilience and mobilization of domestic dairy cooperatives exerted pressure on the state. Short of cooperatives' resistance, the Polish state would have likely implemented a more radical plan for restructuring the sector. On the other hand, the Polish state played a crucial role by pooling foreign capital and channeling it into coherent developmental programs meant at increasing the competitiveness of domestic actors. As such, one can speak of a co-evolution of public and private developmental agency, which successfully combined in the co-production of a developmental public good - competitive upgrading – once the state co-opted cooperatives in its own developmental agenda.

The State's early attempts at reforming the cooperative sector in 1990 proved to be a failure: in spite of new elections, cooperatives chose continuity in their leadership and actively resisted the dissolution of the national Union. Resistance sometimes took on very concrete forms: for instance, as Bruszt and Langbein (2014) also related it, when the Central Union was dissolved in 1990, the membership forcefully occupied the locales at the Warsaw headquarters. In spite of affinities with the emerging Polish Peasant Party (PSL), the mobilization of farmers/cooperative members was spontaneous as they organized a series of protests between 1990 and 1992, culminating in the re-establishment of the Union of Cooperatives⁷⁹. Ultimately, since the 1990 law authorized the re-establishment of cooperative unions after 1991, the sector's organizational structure was hardly different by 1992 compared with the Socialist period. The period between 1989 and 1990 proved to be a fleeting moment of uncertainty, when the radical reformist objectives of the Balcerowicz reforms momentarily stood at odds with dairy cooperatives' long-term interests. However, dairy cooperatives' resistance and more cautious voices in the Solidarity government soon turned the tide. Throughout the year 1990, as the administration was putting new institutions in place for managing privatization, it became clear that dairy cooperatives would be spared: A Ministry of Ownership Transformation (MOOT) was set up in September 1990 in the wake of the "Privatization Law for State-Owned Enterprises" adopted in July 1990. An Anti-

⁷⁹ Interview at the Polish Association of Dairy Cooperatives (KZSM)

Monopoly Office (AMO) was equally established in March 1990 to work in cooperation with MOOT during the privatization phase: MOOT was responsible for privatization, AMO for de-monopolization and anti-trust policy, the Ministry of Agriculture (MAFE) for agricultural policy. The government created an Inter-ministerial Commission for the Privatization of Agriculture comprised of representatives of MAFE, MOOT, AMO and the Ministry of Finance (MOF) for coordinating privatization in agri-food. However, the dairy industry enjoyed a separate status: MAFE set up a “Governmental Committee for Improving the Competitiveness of the Dairy Sector”, followed by the creation of an “Office of the Plenipotentiary (of the Ministry of Agriculture) for the Dairy Sector: By the end of the year 1990, it was clear that instead of dismantling existing cooperatives, the state would participate actively in financing their capitalization (FAPA, 1991).

The resistance and lobbying activity of dairy cooperatives had a deep effect on the state’s developmental strategy for the sector: the National Union of Dairy Cooperatives drafted a document called “Development Strategy for Polish Dairy” in August 1994. In effect, this proved to be the template for the Ministry of Agriculture’s own “Program for Restructuring and Modernizing Dairy” adopted in August 1994. In other words, cooperatives were coopted by the state as the national sector-level developmental strategy directly translated the objectives laid out by dairy cooperatives’ management. The main objectives of the program were the following: (1) advancing concentration in the milk production segment, (2) improving the genetics of the cattle stock by introducing new, more productive breeds, (3) reorganizing producer-processor relationships keeping the cooperative structure, (4) stabilizing production prices against market fluctuations by guaranteeing intervention prices, (5) introducing modern food safety and environmental standards. Between 1994 and 1997, the milk production segment received a total of 355 million zlotys for 9284 individual contracts, with an average of 38 000 zlotys per application (FAPA, 2000). The milk processing segment received 300 million zlotys in 362 projects for an average of 829 000 zlotys per application. Furthermore, it should be stressed that in a cooperative structure such as the one that characterizes Polish dairy, production and processing are integrated: therefore the beneficiaries in both production and processing segments often overlapped as they belonged to a single cooperative. Besides direct access to capital, public agencies also offered intervention prices (see Table 4.7.).

Table 4.7. Intervention Prices on the Polish Dairy Market 1993-1997

	1993/94	1994/95	1995/96	1996/97
Minimal price for milk purchase	0.23	0.25	0.40	0.50
Intervention purchase of butter (in tons)	21.4	8.6	19.2	8.4
Intervention purchase of milk powder (in tons)	24	8	0.17	23.2
Intervention sale of butter in tender system (in tons)	13.5		5.7	8.4

Source: (FAPA, 2000)

Differentiated import duties by product segment were equally introduced: 70% for milk powder, 40% for butter, 35% for yoghurt and cheese (FAPA, 2000). In effect, import duties seemed necessary by 1992 as foreign MNCs entered the market and began importing ready-made dairy products en masse: this point is further discussed in the section on individual firm strategies. As mentioned in an official document by the Foundation for Assistance Programs for Agriculture (FAPA), the use of protectionist tariffs was considered an acceptable bargaining chip in negotiating gradual liberalization with GATT and the EEC: *"In trade negotiations there is a tendency to use the reciprocity principle, i.e. to make concessions only if the other side is making concessions as well. In this situation, one could think that it is useful for Poland to have high trade barriers at the start, in order to negotiate them down in exchange for trade concessions (...) Negotiations on an Association Agreement with the EC are probably the most sensitive issue, and it is in this context that the possibility of tactical use of high initial tariffs is most often mentioned (...) However, the reverse preferences which such an arrangement would involve may be of higher interest to Poland than they are to the EC. In other words, the reciprocity, which Poland is prepared to offer may not necessarily be sought by the EC. If that is true, any tariff reductions which Poland could offer may not provide much leverage to Poland"* (FAPA, 1991).

The state's role was twofold: On the one hand, it pooled foreign capital from various sources and channeled these funds into upgrading investment programs destined at improving the dairy sector's competitiveness (while shielding off foreign competition to the extent that import duties would allow it). On the other hand, it also established new public organizations tasked with the implementation of this modernization agenda. There was a necessary complementarity between the two processes as the coordination and implementation of upgrading investment programs required an expansion and modernization of public administrative capacities. This was also a learning process: the initial lack of direction was gradually replaced with a coherent and centralized system of coordination.

Bilateral aid

One can distinguish between different phases in this process: in a first period, bi-lateral pilot projects constituted a badly needed source of foreign capital necessary for modernizing the sector. In a second period, the state used capital from IFIs to implement new upgrading programs, which necessitated the creation of new regulatory public agencies. These funds would in turn be complemented with additional resources from the EEC/EU and upgrading programs initiated with IFI funding would gradually merge with EU pre-accession instruments.

In the earliest phase, the key sources of foreign capital were EU15 governments who invested in targeted pilot projects. The motivations for Western European actors' involvement were complex: on the one hand, they actually extended to CEE the experience in foreign aid, cooperation and technical assistance, which they had gained in the global South. Scholars such as Lavenex (2009) consider the Eastern European accession process in that regard as an offshoot of Western Europe's pre-existing institutionalized foreign aid and assistance programs. On the other hand, it was equally clear that CEE states represented tangible new markets and investment opportunities for Western European firms: thus, the earliest bilateral pilot projects equally served a prospective function for investment opportunities in the *terra incognita* of post-Communist industries.

One of the notable early bilateral projects in agri-food modernization was a pilot project in dairy initiated by the Netherlands, as early as 1989. The “Turosl Dairy Development Project” singled out the commune of Turosl (northeast of Poland, a traditional dairy producing region): the project sought to establish a “model farm” surrounded with 15 “master farms”. In retrospect, the project’s ambition seems quite unrealistic: *“The project was designed to meet national objectives, including the development of private farming, the intensification of production and the promotion of dairying on the grassland areas. The immediate project objectives were clear, i.e. the transfer of the Dutch model of dairy farming to a small number of farms with clearly specified production targets (FAPA, 1992).* The expectation was that, with substantial foreign capital channeled into a cluster of demonstration farms equipped with modern Western technology, the sheer demonstration effect would somehow lead to modernization spillovers in the region and beyond - as if the problem of Polish competitiveness in dairy had not been rooted in a lack of capital but rather a lack of motivation or proper understanding of Western European agricultural models. This seemingly naïve inconsistency was even singled out by the British consultants who carried out the ex-post evaluations⁸⁰. Notwithstanding this apparent lack of realism, the Turosl project is interesting in as much as it demonstrates the progressive shift from poorly thought-through targeted bilateral projects to a more systematic and centralized management of upgrading policies encompassing an increasing number of public and private actors. Furthermore, it is also illustrative of relatively transparent ulterior motives lurking behind foreign technical assistance.

The first phase of the Turosl project ran between 1989 and 1991 and was financed with Dutch capital and inputs. However, after 1991, in the wake of the Europe Agreements signed between Poland and the EC as well as the implementation of the PHARE program, the EC became the third partner alongside the Polish and Dutch governments. By the end of 1991, EC funding represented 0.7 million ECU, while the Netherlands invested

⁸⁰ „It is less clear what the broader development objective was intended to be – was it to promote an ideal technical model which might be adapted to local realities, or to develop a practical model of dairy farming for Polish conditions? (...) The initial emphasis on the model farm and the transfer, rather than development, of technology would suggest that the objective was rather to provide a demonstration of one model ” (FAPA, 1992).

0.65 million ECU. The Dutch funds were earmarked for technical assistance and the EC funds for the purchase of machinery and equipment. The Polish government agreed to commit 36 million zlotys to the project for infrastructural modernization. The project was operated by a Dutch-Polish steering committee. The Polish secretariat was established by the Ministry of Agriculture, however it is significant that the actual organization was entirely delegated to the Union of Cattle Breeders (FAPA, 1992). The Dutch/EC side of the steering committee was handled by a private consultancy. The suspicion that a supplementary motivation to the project on the Dutch side lay with the potential for increasing exports to the nascent Polish market is difficult to cast away: the Turosl project was fundamentally structured around machinery modernization, and the 30 local farmers targeted by the project not only received direct training but most importantly preferential loans for investing precisely in modern milking machinery. Put simply, the Dutch and EC funds were used for subsidizing loans earmarked for purchasing Western European (Dutch) milking machinery.

Somewhat predictably, the Turosl project failed entirely at entrenching a “Dutch model” of dairy organization in Poland, however it created a strong local discrepancy among local farmers between “insiders” and “outsiders” to the project. A sign of the program’s “success” was that the local beneficiaries lobbied for a long-term extension of the project, which the Dutch/EC partners were happy to extend: thus the initial project undertaken in 1989 actually lasted until 1996 and came under the umbrella of EU pre-accession instrument PHARE. From the available archival material, it seems that the expectation on the Dutch side was that subsidizing the adoption of modern (Dutch) milking machinery in a restricted pool of Polish model farms would raise productivity sufficiently to motivate surrounding farmers initially excluded from the project to invest in similar equipment using other sources of capital. Thus, the Turosl project, under the guise of technical assistance, was in reality little more than a commercial exhibit organized in Potemkin farms where the Dutch creditors hoped to spark local demand for Dutch equipment. However, the principal bottleneck of the project was that it ignored the core problem of developing and transition economies, namely restricted capabilities for accessing capital. The neighboring farmers who were excluded from the project and thus didn’t benefit from preferential loans proved unable to replicate the “Turosl model” – which incidentally also put a natural barrier to the Dutch hopes about an boosted

Polish demand for machinery: *“There is considerable interest in the project on the part of advisory service and neighboring farmers. The latter are adopting at least some of the innovations introduced, e.g. 25 farms outside the project made silage last year. However, it is difficult for farmers to adopt the total package because of its relatively high cost and commercial interest rates exceeding 50% per annum. The project also relied very much on imported machinery (sic), while other farms would not have access to such machinery at reasonable prices and credit terms.”* Finally, even for the beneficiaries, while an increase in output of milk produced was indeed noticed, the financial viability of the project turned increasingly burdensome since even the subsidized credit scheme was difficult to finance in view of low purchasing prices for milk and high fixed costs: *“Thus, production costs are estimated at 2 200 PLN to 2 4000 PLN, but these are heavily subsidized through preferential interest rates. Each additional 1% of interest rates would add over 30 PLN per liter to production costs. These figures must be compared with current milk prices in the area which do not exceed 2 100 PLN, even for the best quality. The inevitable conclusion is that dairy farmers would not be justified in investing heavily, even at preferential interest rates (10%), unless a higher value outlet was available for their milk (FAPA, 1992).”* The conclusion was difficult to escape: the project could neither realistically be expected to fuel private investments by dairy farmers beyond the original beneficiaries only due to the demonstration effect of the “Potemkin farms” – nor could it actually constitute a financially sustainable model in which subsidized loans could finance technology imports in light of lower revenues and higher fixed costs than in the Netherlands: *“The general conclusion of this evaluation is that the initial project has developed a good technical model for improved dairy production but that this model will have to be adapted further before it can be replicated widely in Poland. The basic problems are that it is too expensive and relies too much on imported machinery and equipment (FAPA, 1992)”*,

As exemplified by Turosl, the first, somewhat chaotic bilateral projects were gradually replaced, complemented with- and often retroactively integrated into- the EC's (later EU's) aid and pre-accession instruments, chief of which PHARE. However, what is surprising is that a loan financed by the World Bank proved even more fundamental to the sector's restructuring, competitive upgrading but also to the development of Polish public developmental and regulatory capacities: this program was called ASAL.

Using the World Bank to build state capacities and save cooperatives

Upon integrating the Bretton Woods organizations - the IMF and the World Bank in 1986, Poland was undoubtedly motivated by the prospect of accessing a new source of foreign capital in a very similar situation to Hungary's macroeconomic problems, namely unsustainable levels of foreign debt. On May 4 1993, the World Bank and the Polish government agreed to an Agricultural Sector Adjustment Program (ASAP), which established a cooperation framework for an investment program financed by the World Bank called Agricultural Sector Adjustment Loan (ASAL). ASAL represented 330 million USD, a substantially bigger sum than any of the previous bilateral aid and investment projects. ASAL was not only important for the size of the loan involved but also because it invigorated the state to design and implement an extremely wide-ranging and complex set of reforms, which necessitated the creation of new public agencies: Seven objectives were broken down to 78 monitorable actions and 33 operational projects (MAFE, 1995). ASAL was not only a loan program financing targeted technical assistance projects: it provided the framework for an administrative *aggiornamento* of public regulatory organizations in agriculture, agri-food and rural development. The Foundation of Assistance Programs for Agriculture (FAPA), an organization in charge of overseeing all infrastructural modernization projects as well as credit programs was set up as an implementing organization to ASAL. Similarly, the Agency for Restructuring and Modernization of Agriculture (ARMA), the chief credit agency, was also created under ASAL (MAFE, 1991). The public agency in charge of privatizing agricultural land and Socialist agri-food companies and cooperatives, the Agency for Agricultural Property (AAP), was also created for implementing one of the key objectives of ASAL. Finally, the Foundation for Rural Development (FRD), another fund created for financing modernization investments, was also equally established under ASAL (MAFE, 1991). What is remarkable is that the World Bank and the Polish state had different perceptions of ASAL, which spurred real tensions. The World Bank saw the adjustment loan primarily as a program meant to de-nationalize agriculture and agri-food sectors and create the foundations of a modern, competitive and profit-oriented agricultural markets. Polish authorities however perceived ASAL as a public developmental toolkit, whereby the state could regulate and upgrade its economy. As pointed out in the ex-post evaluation drafted by the World Bank: "*The borrower regards the co-financing of rural*

infrastructure as the first objective of the program, market oriented transformations as the second. The Bank sees an ASAL primarily as a structural adjustment mechanism; the rural investment component as incidental” (World_Bank, 1997). Polish public actors proved able to use the opportunities offered by ASAL “creatively”, for advancing their own priorities, which didn’t stop at privatization.

The construction of ASAL was peculiar: although primarily financed by the World Bank, the 33 individual projects were also often co-financed by specific Western public and private partners. Out of the 33 projects, project nr. 8 concerned specifically the dairy sector under the title “Pilot Programs on Quality Management in the Dairy Sector” (MAFE, 1995). The project was funded by the government of Switzerland with 1 million Swiss francs, the UK government contributed 215 000 GBP and the EC’s PHARE program invested 700 000 ECU. It was comprised of four “phases”, with a dominant contribution by one of the external assistance providers in each: in the first phase which began in January 1993, the main actor was the Swiss government. Four Polish dairy cooperatives took part in the project, first building a traceable database among their suppliers and implementing systematic milk sample analyses, the results of which were kept in a computerized database. In a second phase, a three-week training tour was organized for Polish dairy cooperative management to Switzerland for studying food safety and milk quality traceability and analysis systems, and 180 000 Swiss francs were earmarked for buying modern equipment which enabled the collection of milk twice a day in the collection centers. In the third phase, which began in March 1994, it was the UK government that played the leading role: 225 people received training regarding traceability and milk quality systems as well as on food safety standards ISO 9000 and HACCP. Eleven dairy cooperatives were selected for the implementation of new quality systems, while the program also provided training for technical specialists in the Dairy Technological Institute of Agricultural Academy at Olsztyn and the Dairy Institute in Warsaw: this part of the project sought to build up technical expertise in the two key scientific institutes in order to monitor milk quality consistently and more importantly for enforcing and monitoring the ISO 9000 and HACCP food safety standards amongst the 11 dairy cooperatives that took part in the project. At the end of the third phase, a further training was provided specifically for dairy processing plant managers for refining quality control systems at the plant level. Finally, 700 000 ECU originally

earmarked by PHARE for technical assistance in the dairy sector already in 1993 – were eventually used in the last phase of the project in 1995-1996 for accrediting laboratories and the two dairy institutes and provide further, larger-scale trainings to both farmers and dairy processing plant management regarding food safety standards (MAFE, 1995).

Two points are worth mentioning: Project nr.8 (just like the remaining 32 others) actually served as a bridge between the early bi-lateral aid and technical assistance projects financed by foreign public donors and later multilateral investment and credit programs supervised and financed by the World Bank and the EC up until the late 1990s. More fundamentally, the Polish state and the beneficiaries (dairy cooperatives) were far more than passive rule takers: ASAL notably enabled the state to extend its regulatory capacities by setting up key agencies such as FAPA and ARMA, which were necessary for implementation and monitoring. An important disagreement grew increasingly clear between the World Bank and Polish state and non-state actors: while the former urged Poland to get rid of cooperatives, Polish actors on the contrary used these funds for saving and upgrading them. Most of ASAL objectives didn't stir disagreement between the donors and Polish beneficiaries: administrative capacity building, infrastructural investments and modernization, the introduction of modern food safety standards were commonly shared objectives. However, the issue of privatization was more contentious when it came to dairy: the Ministry of Agriculture (MAFE) alongside the newly created FAPA managed to take dairy off the list of targeted sectors for massive privatization even when donors expressly pushed in that direction (World_Bank, 1997). Instead, Polish public actors decoupled ASAL objectives: specific sectors, such as sugar would be prime examples of privatization, following a similar pathway to Hungarian dairy: By 2010 only 4 sugar producers remained on the market, 3 of them were foreign-owned (Judzinska, 2012). However, Polish implementing agencies used the funds under ASAL and PHARE to invest in upgrading dairy cooperatives, even effectively bailing out those that were on the verge of bankruptcy in the early 1990s. In July 1990, 800 billion zlotys were allocated to restructuring the dairy sector, out of which 250 billions were earmarked for credits: by 1991, this credit line had been already exhausted but it had served to save 260 dairy cooperatives, which had been on the verge of bankruptcy and liquidation (MAFE, 1991).

Rejoined upgrading efforts on the way to EU accession

By the time ASAL was completed in 1996, the landscape had changed entirely compared with the disorganization and initial lack of trust between the state and cooperatives, which had prevailed in 1989-1990. By the mid-1990s, the elements of a stable developmental alliance between state and non-state actors were in place – the scenario of a re-privatization of cooperatives had been abandoned while an extended public administrative apparatus comprised of modernization program implementing agencies and credit purveyors such as FAPA and ARMA had accumulated substantial experience in project management and the centralization of foreign capital sourced from different transnational partners. Dairy cooperatives had benefitted from a steady stream of capital since 1990, which enabled them to overcome the first basic challenges in adapting to a new competitive environment. Subsequent modernization investment programs pursued in advancing the objectives layed out in the 1993 ASAL program – most importantly upgrading the quality of fresh milk, which was still unsatisfactory by EU standards. The PHARE program “Quality Management in the Dairy Sector”, implemented between 1996 and 1998 was in fact a direct offshoot of ASAL – only the funding source changed as EU funds replaced the World Bank: trainings in ISO 9000 quality monitoring was delivered to a group of 195 people representing key dairy cooperatives located in Gora Slaska, Lubawa, Mragowo, Nowy Tomsyc, Raciaz, Radzyn Podlaski and Sieradz Public laboratories and veterinary services equally received trainings as well as new machinery down to the regional level in Opole, Malbork and Koszalin (FAPA, 1996).

There were also setbacks: in 1997, the EU’s Food and Veterinary Office Inspectorate banned Polish exports to the EU arguing that food safety standard compliance was not satisfactory (Judzinska, 2012). It remains somewhat doubtful whether the decision was justified or if it was an attempt at protecting EU15 dairies from the comparative advantage of low cost Polish exports, which, eventually, did flood the EU market. Although Polish dairy cooperatives certainly lagged behind in ISO 9000 and HACCP certification as well as in the overall quality of fresh milk as described in the section on indicators, it has to be kept in mind that food safety standards are regularly used as non-tariff trade barriers and bargaining chips in international trade liberalization

agreements. If anything, the 1997 ban actually reinforced cooperation between the state and dairy cooperatives: the same year, a program called “Aid for ISO 9000 Certification” officially certified for the first time a group of large and middle-sized dairy cooperatives as ISO 9000 and HACCP compliant: Spomlek, Piatnica, Gora, Sertop Tychy, Gora, Lubawa, Sieradz, Kolno and Radzyn Podlaski were the beneficiary cooperatives. Laggards received further help in a program called “Quality Improvement in Polish Dairy and Fisheries”, which ran between November 1999 and December 2000: a further 17 cooperatives received help in view of HACCP certification, while another 3 were brought to ISO 9000 compliance. The direct result of this program was that, eventually, 25 cooperatives received an export certification to the EU by 2002 (while only 4 officially complied with ISO 9000 in 1997)⁸¹.

In 1999, Poland adopted the EU’s classification system of milk quality in 3 classes – thus dairies had to test their products for various indicators (such as germ count, fat content etc.) and disclose that information. In 2000, Poland passed a new law, which prohibited processors from buying “third class” (lowest quality) milk (thus restricting this type of milk to household consumption or sale in local wetmarkets) (Dries & Swinnen, 2007, p.426). By 2003, processors couldn’t accept second-class milk either: the objective was to upgrade all processed milk to first class level by EU accession in 2004. The “carrot” was an incentive subsidy paid for first class milk between 2002 and 2004 (Malak-Rawlikowska, 2006). Overall, the qualitative upgrading of milk proved successful as first class milk purchases increased by 33% between 2002 and 2003, and thus 85% of milk complied with EU criteria by 2003. However, Poland obtained a further safeguard during EU accession negotiations: the EU Commission accepted that Poland continue financing dairy upgrading programs even after accession alongside the objectives fixed in the 1994 document “Development Strategy for Polish Dairy” co-produced with cooperatives – on the condition that these differ from the criteria of EU structural fund support: this proved equally important as it allowed ARMA to finance 14,8 million euros on preferential credits in 2003 (compared to 6 million in 1995) (Malak-Rawlikowska, 2006).

⁸¹ Interview with experts Adam Bugala and Jan Falkowski, IERIGZ

Conclusion on public policies

In spite of hesitations in 1989, the Polish state eventually chose to preserve domestic dairy cooperatives inherited from the Socialist era. The alluring sirens of radical restructuring, re-privatization and modernization through FDI were quickly repelled as it became clear that farmers were determined at keeping the organizational structure, which they had managed to safeguard for over a century – even against the Stalinist project of nationalization. Instead of fighting them, the Polish state ended up coopting cooperatives as co-managers of their own modernization: the state and cooperatives co-produced the 1994 template for restructuring the sector. Compared with the fast-track access to capital afforded by the Hungarian integrationist strategy via FDI, the Polish state thus embarked on a more difficult journey: it was financially costly, it necessitated institutional innovations and it required a lengthy learning curve. What is particularly striking is that the Polish state's role in restructuring the dairy sector mirrored the "classical" pathway of autonomist developmentalism among 20th century late-industrializers, which shows that even in post-Socialist CEE, modes of transnationalization varied considerably at the sector level between countries confronted with similar problems. In light of the competitive position that Polish dairy producers eventually attained in the EU market, the Polish pathway performed objectively better than the Hungarian model. In fact, after a decade of continuous upgrading programs, Polish dairies thrived in open markets: after EU accession, the state actually retreated from pro-active interventionism – unlike Hungary where it was coerced into action because of collapsing competitiveness. In 2012, when the EU Commission proposed a new set of regulatory tools to member states in the "Milk Package", neither the Polish state nor Polish dairy cooperatives took advantage of this opportunity: by the time the EU began encouraging member states to establish multi-stakeholder organizations at the sector level in a bid to defend the interests of domestic dairy producers, Poland had already accumulated twenty years of experience in running a thickly institutionalized developmental coalition, which had not only saved "obsolete" Socialist cooperatives, but transformed Poland in one of the big global producers and exporters of dairy products.

Part 4. Firm Strategies

Large domestic cooperatives

Although the developmental pathway of the Polish dairy sector proved largely successful both in the sector's improving competitive position on transnational markets and in terms of the inclusiveness it offered to domestic actors, differences in size and strategies among Polish dairies reveal different opportunities and constraints. While the market is substantially less concentrated in Poland than in Hungary, there are marked differences between a handful of market leaders and a large number of smaller dairies, which often try to specialize in niche markets. Two flagship companies stand out in particular – Mlekpól and Mlekovita, respectively first and second in terms of market share with approximately 13% each and yearly revenues in excess of 3 bn PLN (710 million euros) (Janiuk, 2014). The trajectory of both firms is remarkably similar: both are domestically owned cooperatives, whose origins can be traced back to the early 20th century. They were both nationalized in 1951, and re-instituted as cooperatives in 1957, while both have weathered out the transition under the leadership of directors who had already been at the helm of the cooperatives under Socialism: a member of the Polish Peasant Party, Edmund Borawski has been Head of Mlekpól since 1982 while Dariusz Sapinski became the Head of Mlekovita in 1985⁸². Borawski is also an active politician in the Polish parliament (Sejm), where he has been working in the Special Committee on Cooperative Law since 2011: it is not coincidental that two of his assistants there are former members of Mlekpól⁸³. The successful trajectory of both companies followed similar landmarks: The first phase was the introduction of premium UHT fresh milk on the domestic market in 1995. By EU accession in 2004, both cooperatives complied with EU food standards mandatory in the dairy sector – ISO 9000 and HACCP. Furthermore, Mlekpól also made separate investments for complying with the UK's very own BRC standard: Mlekpól's products can thus be exported to the UK market through British retail chain Tesco. The 1990s were marked by a rapid expansive strategy for both Mlekpól and Mlekovita – the two companies acquired a number of processing facilities

⁸² Source: <http://stara.wysokiemazowieckie.pl/37.php> accessed 23/03/2014

⁸³ Source: <http://www.mlekpól.com.pl/> accessed 01/03/2013

and smaller cooperatives throughout the country: while Mlekovita is originally based in Eastern Poland (Wysokie Mazowieckie), its collection and distribution centers cover today the entire country – which reflects how the production and distribution facilities of smaller dairies were gradually integrated into a complementary national network of 14 distribution centers⁸⁴. Mlekpól followed a similar pathway: the cooperative was based in Grajewo, also in Eastern Poland, but it went on to absorb 11 dairies between 1995 and 2005 spread across Poland. Mlekpól represents today 14 000 farmers-owners while the cooperative employs a further 2300 people. It purchases 13% of all milk that is produced in Poland and one third of its production is destined for exports to the EU market, predominantly in EU15 countries⁸⁵. Although Mlekpól's exports to the EU market are still concentrated in the lower value added milk powder product segment (64% of its exports), it is present on the domestic market in all value added segments with 500 different products and it is the only Polish dairy company which operates its own RD department. Mlekovita is equally diversified with a range of 400 products, and it also exports 30% of its production. Mlekovita's export strategy is particularly innovative: It is the first Polish dairy company, which opened production subsidiaries abroad. In 2009, Mlekovita entered the Russian market by building a processing plant in the Russian exclave of Kaliningrad, close to the Polish border⁸⁶. It targeted the Russian market in the high value-added segment by focusing specifically on mozzarella and feta cheese produced in Kaliningrad from local fresh milk supplies⁸⁷: instead of relying on smallholders however, Mlekovita built two large scale farms with more than 1000 cows⁸⁸. It also opened its own distribution channels operating ten stores in Kaliningrad and two stores directly in Moscow. On the domestic market, Mlekovita also innovated by building a Cash and Carry retail store near Warsaw in 2013, where it acts as a

⁸⁴ This is also interesting because in the Hungarian context, MNCs pursued a similar expansionist strategy in the 1990s – however, they largely failed at building complementarities between different regional production facilities. Source: <http://www.mlekpól.com.pl/> accessed 01/03/2013

⁸⁵ Source: <http://www.bialystokonline.pl/mlekpól-zarabia-i-inwestuje-w-swoje-zakłady,artykuł,11230,4,66.html> accessed 01/03/2013

⁸⁶ Interview with Ms. Agnieszka Maliszewska, Polska Izba Mleka

⁸⁷ Source: <http://www.podlaskie.strefabiznesu.pl/artykuł/mlekovita-najwieksza-fabryka-swiata-44124.html> accessed 16/06/2014

⁸⁸ Source: <http://www.forbes.pl/mlekovita-dariusza-sapinskiego-sukces-mlekiem-plynacy,artykuły,176958,1,1.html> accessed 19/06/2014

wholesaler: in conjunction with its Russian operation, Mlekovita's business model is particularly surprising as the company is not merely attempting to carve out new export markets but it also invests in setting up independent distribution channels to avoid intermediaries such as retail chains – a strategy usually reserved to the biggest MNC food processors. What is more, Mlekovita also entered a partnership with Lithuanian food wholesaler Prefita: using Prefita's wholesale stores in the Baltic states, Mlekovita products are sold through Mlekovita Baltica in the region. Overall, Mlekovita's marketing strategy both domestically and on export markets is highly innovative as it establishes new distribution channels by eliminating intermediaries, which reduces dependency on large retail chains: the cooperative carves out a place in foreign export markets by setting up its own distribution and production facilities in the neighboring countries. Since 2012, there have been insistent rumors that the managements of Mlekpól and Mlekovita would be negotiating a merger of the two companies, which would not only create a giant on the Polish dairy market but also one of the biggest dairy companies in Europe⁸⁹. The market position of the two firms is so solid that domestic and foreign competitors have little prospect of catching up: instead of competing on quantities, the latter often specialize in niche products with high value added such as specific types of cheese and yoghurt drinks.

The challenges of medium and small Polish dairies

Since the Polish market remains substantially less concentrated than EU15 or even the Hungarian market, the two giants' combined market share still leaves a relatively large space for competitors. However, whether domestic or foreign owned, cooperatives or limited liability companies, virtually all other dairies capture market shares that are orders of magnitudes below the two flagship processors (with the partial exception of Danone). For Polish dairies, two strategies remain open: medium-sized dairies attempt to catch up with Mlekpól and Mlekovita before the latter's foreseeable merger. Smaller domestic dairies try to specialize either in higher value added products or in specific export markets. The first strategy is exemplified by Polish cooperatives such as Lowicz,

⁸⁹ Source: <http://www.pb.pl/2446803,30410,pojedynek-gigantow-na-polskim-rynku-mleka> accessed 19/06/2014

Piatnica or Spomlek⁹⁰. Lowicz is a good example of the new challenges for medium sized Polish cooperatives: it is a dairy cooperative set up in Russian-occupied Poland in 1906 under the leadership of Wladylaw Grabski – a Western educated aristocrat who would become a prominent figure of independent Poland as he was elected Prime Minister in 1920⁹¹. In the wake of the 1990 Law on Cooperatives, which attempted to renew management through mandatory elections, the membership elected Jan Dabrowski as Head of the cooperative, a young technical engineer who had been working at the cooperative since 1983: just like his peers at Mlekpól and Mlekovita, he has been in place ever since the 1980s. Lowicz is today the fourth biggest dairy with a market share of 6% behind Mlekpól, Mlekovita and Danone. Throughout the 1990s, the cooperative followed a similar trajectory to Mlekpól and Mlekovita, the difference mainly lying with its smaller size: Lowicz had half the sales revenues of its eastern competitors in 2012 (330 million euros) (Janiuk, 2014). The cooperative also tried to gradually expand capacities by absorbing smaller processors - between 2006 and 2013, it bought 6 dairies – however a notable difference is that it is weaker in exports than its bigger rivals: while Lowicz exports to the EU and Eastern markets (Russia, Mongolia, China), exports only represent 17% of its production⁹². Due to lower capitalization and capacities, it failed to exploit the export opportunities afforded by EU accession, which benefitted Mlekpól and Mlekovita. The problem is that an inward development strategy on the domestic market is getting more difficult to sustain in an increasingly competitive environment: Alongside Mlekpól and Mlekovita, Lowicz was also supplying retailer Biedronka (owned by Portuguese Jeronimo-Martins) but in March 2015, it was de-listed as a supplier – officially as a result of unsatisfactory quality⁹³. Lowicz thus exemplifies a problem for middle sized domestic cooperatives, which didn't manage to carve out substantial export

⁹⁰ Interview with Agnieszka Maliszewska, Polska Izba Mleka

⁹¹ From then on, the Lowicz cooperative followed the typical route of commercial expansion throughout the 1930s, stopped short by the second world war, nationalization in 1951 and re-established cooperative autonomy in 1957.

Source: <http://www.mleczarnia.lowicz.pl/lowicz/index.php?strona=historia> accessed 01/06/2015

⁹² Source: <http://www.portalspozywczy.pl/mleko/wiadomosci/osm-lowicz-wyda-na-inwestycje-70-mln-zlotych,114835.html> accessed 01/06/2015

⁹³ Source: <http://www.strefabiznesu.pomorska.pl/artukul/mleko-mleczna-dolina-z-biedronki-juz-nie-będzie-produkowane-przez-osm-lowicz-mlekpól> accessed 01/06/2015

market shares and whose market share on the Polish market is also threatened by larger competitors: short of innovative distribution channels such as Mlekovita, Lowicz depends on stable relations with retail chains, and the recent de-listing had important reputational consequences on the cooperative's products.

MNCs vs domestic firms

Unlike in Hungary, MNCs never managed to threaten the dominant market position of Polish dairies: not only was there a strong developmental coalition in place between the state and cooperatives, which strengthened the competitiveness of domestically owned dairies, but – as discussed below – establishing a stable supplier base proved very costly. By contrast, domestic cooperatives *de facto* enjoyed a guaranteed access to an extensive supplier base via their own membership. However, this doesn't mean that foreign investors didn't try to penetrate the Polish market, only that they specialized in specific, high value added market segments. Among MNCs, only Danone is a major player in the overall dairy market with a market share of 6% (similar to Lowicz) (Janiuk, 2014), while the rest of foreign firms specialize in a very restricted range of high value added products. FDI penetration in the early 1990s was initially motivated by domestic demand rather than using Poland as a stepping-stone to re-importing towards EU15 markets – a fact which can be explained by import tariffs in place at the time, transportation costs and pre-existing subsidiaries in Western Europe (Zinsou, 1997).

A common strategy for MNCs was to begin prospection by testing local demand for their products: instead of investing directly in purchasing processing facilities, many MNCs initially functioned as importers, often building joint-stock companies with a Polish partner, which meant a three year tax exemption Danone for instance set up a joint-stock company in 1990 in Wola, near Warsaw, which was only importing finished products from France until 1992. Similarly, German dairy Zott set up a distribution center in Wroclaw in 1992 for yoghurts imported from Germany (Ricard, 2010). Another German dairy firm, Hochland, adopted the most aggressive strategy: it had begun selling imported cheese from Germany as early as 1989 which it would sell in their original German packaging as a means to exploit the appeal of Western products. However, its marketing strategy proved too successful as it raised concern among Polish

cooperatives, which successfully lobbied the state to raise import duties on cheese. Hochland reacted by selling at a loss until demand for its brands would be secured. However, it became clear for MNCs after 1992 that if they wanted to remain on the Polish market and continue supplying the demand they had established via their importing operations, only local processing facilities could help them overcome import duties and the ire of domestic producers (Ricard, 2010). Danone thus began producing locally in 1992, Hochland bought and modernized an old cheese processing plant in Kazmierz in 1995 and Zott bought a processing plant in Opole (Southern Poland) in 1999. Other MNCs also invested in local production facilities in the mid-1990s such as French Bongrain and Lactalis: Bongrain bought a processing facility near Warsaw in Kierniewice and another one near Gdansk in Paslek, while Lactalis (owner of the President brand of butter and cheese) acquired a limited liability cheese processor, Polser in 1996. Although these firms have remained on the Polish market, the challenges often proved bigger than expected for other foreign investors: integrating local production capacities that lagged behind in technology and were (initially at least) utterly incapable of adapting to modern supply chains and food standards proved costly. For instance, the quality of fresh milk among its suppliers was so bad that Danone resorted to supplying its farmers with animal feed which it imported itself from Dutch company Provimi (Ricard, 2010; Zinsou, 1997). This sort of technical setback proved overwhelming for a number of MNCs that were not prepared to tackle organizational problems among undercapitalized small farmers operating with obsolete technologies. After initial exploratory investments, a wave of MNCs left Poland at the end of the 1990s: Friesland left in 1998, Nestlé in 2003, Campina and Avonmore in 2004. This also corresponds to the period when the same MNCs progressively left the Hungarian market (later followed by a subsequent wave of departures in 2013-2015): in Poland however this wave of market exit didn't have dramatic consequences on the sector's organization and viability since MNCs had never represented but a small fraction of dairy processing.

MNCs that remained in Poland were those that successfully surmounted their suppliers' backward technology and undercapitalization: while the present thesis rejects the claim that FDI was the crucial factor behind the competitive modernization of Polish dairy as argued by Swinnen et al., the work of these authors nonetheless points at important investments on the part of MNCs directed at improving the capacities of their own

suppliers⁹⁴. Overall, successful strategies among MNCs that remained - such as Danone, Zott, Hochland, Bongrain and Lactalis - rested with a specialization in niche products such as premium cheese and yoghurt drinks: MNCs couldn't outcompete domestic dairies that benefited from an extensive supplier base as production and processing are strongly integrated in cooperatives. While big domestically owned cooperatives regroup tens of thousands of farmers-producers, MNCs are directly confronted with the problem of land tenure fragmentation: in 2008, 87% of dairy farms still had below ten cows (Bryla & Domanski, 2012). Given the high costs involved in stabilizing even a smaller technologically backward supplier base, MNCs couldn't establish vast supplier networks the likes of which Mlekpól or Mlekovita could rely on: thus, MNCs couldn't outcompete domestic dairies on volumes. However, MNCs' competitiveness lay with substantially easier access to financial capital and technologies than their domestic competitors: these assets could be efficiently exploited in high value added market segments.

This in turn creates challenges for smaller Polish dairy processors. If Łowicz exemplified the competitive challenges for medium sized domestic processors that pursue an inward-oriented strategy in a wide range of products, a recent case study by Domanski and Bryla (2012) focusing on Bakoma illustrates the difficulties of smaller Polish dairies that specialize in premium products: a market segment where MNCs are tough rivals to beat. Bakoma is an atypical Polish dairy. It was set up in 1989 as a joint-stock company between Polish engineer Zbigniew Komorowski and an American businessman of Polish descent, Edward Mazur, who had been working as a marketing representative for US firms in Socialist Poland since the 1970s. Mazur contributed with capital and connections to US- and EU15 early foreign investors, while Komorowski provided land and infrastructure. Bakoma specifically targeted the yoghurt segment from the beginning and entered a five-year licensing agreement with German dairy company Onken in 1992, which provided the technological know-how for introducing a modern line of products. In 1998, the company was introduced on the stock exchange while Mazur sold his shares to Danone the following year⁹⁵. Initially, Bakoma proved highly

⁹⁴ Typically, MNCs would guarantee collateral for loans contracted by their suppliers from commercial banks (Dries & Swinnen, 2005).

⁹⁵ As Domanski and Bryla (2012) single it out, Danone's decision was partly motivated by the desire to control a potential competitor: which explains why the dairy giant would accept only 18% of votes at the Board whereas it came to control 52% of Bakoma's shares.

successful in the premium yoghurt segment with domestic and foreign firms, however, it became clear by the 2000s that unlike low value added products where advertising plays a lesser role, financial success depends on marketing for this range of products - which necessitates substantial investments. And here the financial advantages of MNCs re-asserted themselves. Although Danone, Zott and Bakoma jointly control 80% of sales in the premium yoghurt category, differences in marketing expenses are substantial: while Bakoma spent 18 million PLN on advertising in 2008, Danone could afford 160 million PLN and Zott 30 million PLN. In parallel, Bakoma started to lose ground to its MNC competitors: in 2001, Bakoma had a market share of 18% in the premium yoghurt segment, Danone 28% and Zott 19%. By 2008, Danone increased its position to 40%, Zott to 23%, while Bakoma's position decreased to 14% (Bryła & Domanski, 2012, p.631). Furthermore, there has been speculation over German dairy giant Müller's plans to enter the Polish market precisely in the same product category – which would undoubtedly accelerate Bakoma's marginalization even further.

Bakoma's trajectory cannot be generalized: the choice to specialize in a small market segment is not necessarily a bad option for medium dairy processors. Piatnica for instance is a domestic cooperative, which specialized entirely in cottage cheese: its exports are minimal (4%) but it controls 60% of the domestic market in this category⁹⁶. However, Bakoma's dilemma represents a real problem for smaller domestic dairy processors, which can't compete with giants on volumes and choose to specialize in more lucrative market niches: in these segments, the stronger financialization of MNCs represents a strong competitive challenge.

A brief note on different constraints and benefits for domestic firms

A brief overview of different firm-level strategies shows that the clear winners of restructuring were the biggest domestic dairy cooperatives, which could efficiently exploit a vast supplier base, directly integrated to a network of processing plants. Concentration in the Polish sector is still underway: there is every reason to expect flagship

⁹⁶Source:
<http://www.portalspozywczy.pl/mleko/wiadomosci/osm-piatnica-produkuje-dla-biedronki,23007.html>
accessed: 01/06/2015

cooperatives to continue their domestic expansion strategies by buying out smaller cooperatives and private processors – and there are equally strong reasons to expect mergers between the biggest Polish cooperatives, which would create new giants on the EU market. The prospects of smaller domestic cooperatives are more problematic: as Lowicz illustrates it, competing with the big players in volumes proves increasingly difficult: even if food safety standard compliance is achieved, lower quality products can result in a loss of distribution channels. An alternative strategy – specializing in more lucrative market segments instead of a wide range of products – is equally challenging as outcompeting MNCs on marketing strategies, financialization or RD is difficult for domestic dairies. This point also illustrates the argument presented in the first chapter: the higher the technology content of an industrial sector (or even a range of products in this case), the more patent are the disadvantages of late-industrializers, where a long-term scarcity of financial and human capital put a limit on innovation feedback loops.

Conclusion: the co-production of developmental upgrading in an autonomist model

The developmental outcomes in terms of economic competitive upgrading and inclusiveness for domestic private actors in the transition period paints a fundamentally different picture compared to Hungary: Surprisingly, the Polish dairy sector began its post-Socialist journey under worse conditions and facing deeper structural problems than its Hungarian counterpart. Agricultural land and thus the production segment of the dairy supply chain had been traditionally extremely fragmented, while the quality of fresh milk and the international competitiveness of processed dairy goods was extremely weak in 1989. In spite of these structural difficulties, Poland became the world's 13th biggest dairy exporter in 25 years and the dairy sector can arguably called one of the clearest winners of EU accession. Just as importantly for our theoretical framework, the dairy sector is still controlled primarily by domestically owned cooperatives.

This chapter argues that a number of factors explain such a radical reversal of fortunes: long-term historical-institutional legacies had created stronger resources for cooperatives to fight for their survival at the onset of transition. Polish dairy cooperatives showed that as they had resisted nationalization in the 1950s, they would

also resist re-privatization after 1989: the fact that the state never managed to get full ownership of productive assets in the sector during the Socialist era also hindered the capacity of the most radical reformists in the Balcerowicz administration to follow a Hungarian model by selling off these assets to foreign investors. In that regard, FDI penetration was checked by long-term historical legacies. Nonetheless, the success of Polish restructuring was far from predictable in 1989: even if re-privatization was avoided, the sector needed tremendous investments, which neither the state nor the commercial banking sector could finance. The determining feature of successful competitive upgrading rested with the coordinative role of the state, which learned how to pool foreign capital from a variety of creditors and aid providers and which coopted cooperatives in designing a developmental agenda for modernizing domestic capacities. In that sense, Poland illustrates the successful co-evolution of private and public capacities, which co-produced developmental upgrading. This pathway also corroborates Hirschman's insights as well as later institutionalist approaches to economic development: a scarcity of resources is one thing, what matters however is how public and private actors coordinate and recombine (scarce) resources.

The Polish sector's trajectory also questions a fundamental axiom of post-Communist transition in CEE, namely the alleged necessity for dismantling the vast majority of industrial capacities inherited from state Socialism: throughout the 1990s, the dominant opinion in CEE was that Socialist firms and conglomerates were simply too outdated and too unproductive to survive under the conditions of open markets. Poland's dairy sector shows on the contrary that with dedicated public assistance, even an objectively uncompetitive sector could not only be saved but even transformed into a free market champion that went on to flood export markets, once it had been upgraded sufficiently and after the political barrage to it accessing foreign export markets was removed.

Finally, it is also worth emphasizing the functional role played by the long decade between 1989 and EU accession in 2004. Although the promise of full EU membership was continuously delayed throughout the 1990s frustrating CEE voters and elected officials, it has to be acknowledged that this long waiting period in the EU's antechamber could also serve a highly positive developmental role for specific sectors. In Poland's case, this transitory period allowed the state to use support mechanisms that would be

later banned inside the EU's common market such as import duties and a variety of subsidies, in conjunction with modernization investment programs financed from bilateral aid, EU pre-accession funds and even the World Bank's adjustment loans. In other words, the pre-accession phase functionally offered a place for nurturing an infant industry in a relatively protected environment: a strategy which early industrializers in the West also utilized before conquering foreign markets.

Chapter 5

Part 1. An overview of diverging developmental pathways in the Hungarian and Polish dairy sectors

Hungary: From failed *integrationism* in the 1990s to *re-domestication* in the 2000s

Hungarian dairy's form of post-Communist restructuring and integration to transnational markets occurred through MNCs that rapidly went on to control the entire sector not only in terms of domestic and export market shares, but in the form of direct ownership over productive assets. This period was marked by an apparent *laissez-faire* attitude on the part of public authorities: intervention on the market was minimal after the state had overseen the transfer of property rights to foreign investors during the privatization phase, which was mostly complete in processing and retail by the mid-1990s. We have shown in the second chapter that a vast literature on competitive upgrading would expect MNCs to play a highly positive role by compensating for a lack of capital and technology, which neither the state, nor domestic firms possess. However, in the Hungarian case, in spite of these theoretically grounded hypotheses for expecting economic upgrading, the transfer of ownership rights to MNCs was accompanied by a gradual competitive collapse of the sector, a breakdown of vertical coordination along the supply chain and a strongly exclusionary process, which forced farmers and domestically owned processors out of the market.

In a second period, which began at the very end of the 1990s, MNCs in the processing segment gradually began leaving the domestic market. This process was reinforced by the minority of domestically owned processors, which enlisted the state to play a more proactive role in regulating the sector in countervailing the buyer power of MNCs. During the 2000s, a process of re-domestication thus took place, where the formerly foreign-owned processing sector was gradually bought back by a small pool of domestic actors – specifically the agri-food empire of a billionaire tycoon and a newly created

cooperative of market-savvy producers. In parallel, the state enforced a series of increasingly adversarial regulations not only limiting the buyer power but also the market share of MNCs in the retail segment. This second period is in turn marked by a slow recovery in the value added content and trade competitiveness of Hungarian dairy products although farmers are still marginalized, even when their plight legitimizes regulatory action: farmers remain largely fragmented, without a secure access to investment capital which could guarantee them a stable position as suppliers to processors and supermarket chains.

Poland: the unforeseen successes of an autonomist developmental strategy

The Polish trajectory offers a stark contrast, as both the mode of transnational integration of the sector, the developmental outcomes thereof – as well as the method and timing of public intervention – were almost symmetrically opposite to the Hungarian pathway.

In the Polish case, the 1990s were marked by a different form of restructuring: instead of relying on FDI and foreign ownership for engineering competitive upgrading, public interventionism played a crucial role. The state offered a legal safeguard to the cooperative form of ownership, it authorized the renaissance of cooperative unions and it coopted dairy cooperatives as co-managers in an ambitious modernization plan, which spanned over fifteen years. The consolidation of this alliance also necessitated strong social capital and mobilizational resources among dairy farmers, who fought for organizational continuity in the sector. One consequence was that the cooperative form of production remained the defining organizational model of vertical coordination where producers (farmers) and processors were integrated in a single structure. The second consequence was that MNCs never managed to fundamentally challenge the market share of domestically owned dairy cooperatives neither on the domestic- nor on export markets: The Polish state not only blocked dairy cooperatives from being privatized to MNCs but it also bailed them out when financial bankruptcy would have forced them to seek foreign investors. The starting conditions for the sector's restructuring were mired by deep structural problems: land tenure and dairy production had been historically fragmented in Poland since the mid 20th century, which

made milk collection and processing challenging even within a cooperative format in light of heavy transaction costs. Technology was severely outdated: the genetic stock of the herd, as well as extremely restricted access to capital among farmers translated into low value added products, extremely low productivity and an incapacity to comply with basic modern quality and food safety standards – thus also limiting the export markets where Polish products could be sold. In spite of these fundamental problems, the Polish state utilized a variety of capital sources from foreign actors – bi-lateral aid, adjustment loans by the IMF and the World Bank, as well as the EU’s pre-accession funds – to invest massively in the competitive upgrading of dairy production and processing. The first challenge – providing the necessary capital for investing in the sector’s modernization – was thus efficiently overcome by the state, which utilized all its available sources of foreign capital. A second challenge, which Polish public actors had to overcome necessitated upgrading the state’s own administrative and regulatory capacity for overseeing this program of modernization. New institutions – public regulatory agencies specialized in agri-food and dairy in particular, veterinary inspectorates, public credit agencies – alongside coherent long-term developmental planning had to be set up and learnt. The Polish state proved highly efficient in utilizing the opportunities afforded by technical assistance, which the EU’s gravitational pull afforded during the pre-accession phase for learning how to set up and coordinate public bureaucracies, which could coordinate various actors, mobilize resources and monitor the implementation of specific policies. These efforts were sustained throughout the 1990s by a stable coalition between the state and domestic dairy cooperatives, which became co-managers in their own modernization. As such, one can speak of a co-evolution of public and private capacities in Poland, where development was ultimately *co-produced* by a developmental alliance in line with the definition provided by Elinor Ostrom: “*coproduction is a process through which inputs from individuals who are not part of the organization are transformed into goods and services*” (Ostrom, 1997). As such, economic development – understood as an increase in competitive positions and an inclusive distribution of profits for domestic actors – can arguably be called a co-produced public good in Poland. By the time the country joined the EU, this strategy paid off: Poland had managed to upgrade standard compliance and the financial viability of dairy cooperatives to a point where they could efficiently “withstand the competitive pressure” of an open market. In fact, not only did Polish dairy cooperatives survive, but

after they were given full access to the EU's market, the Polish dairy sector became one of the world's foremost exporters within a decade. Once the competitiveness of the sector had been upgraded to a sufficient level, the Polish state gradually retreated from market interventionism: after 2004, it refrained from experimenting with new, "creative" forms of regulatory support or state aid like Hungary. In fact by 2012, when the EU Commission proposed new regulatory tools for strengthening the bargaining power of domestic producers vis a vis MNCs, and incentivized the creation of new sector-level institutions of multi-stakeholder representation and coordination – the Polish state as well as Polish dairy cooperatives considered these instruments largely superfluous.

Part 2. Explaining the puzzle

How Polish and Hungarian Dairy Sectors Diverged: differentiated public policies

Different public policy answers to the structural lack of capital

Different policy choices for solving the question of access to capital (and to a lesser extent technology) contributed to entrenching diverging modes of transnationalization. Contrary to late-industrializers in the Global South in previous periods, the sources of foreign capital were substantially reduced for Poland and Hungary: unlike South East Asian economies, they couldn't count on foreign creditors to continue financing their budgets as they had already been entangled in a debt crisis by the early 1990s. In this situation, the available sources of foreign capital would take on different shapes: IFIs and the EU's financial transfers were initially the only sources on which the state could count. Surprisingly, Poland even utilized a structural adjustment loan from the World Bank called ASAL for saving domestic dairy cooperatives from bankruptcy. Later, the Polish state built a complex institutional framework for pooling domestic and foreign capital, and channeled it specifically for the investment needs of domestic agri-food firms (among which dairy): newly created public organizations such as the Agricultural Modernization Agency (ARMA) and the Foundation of Assistance Programs for Agriculture (FAPA) were tasked with coordinating foreign capital accessed from the World Bank, bilateral aid from Western Europe, and the EU's early assistance programs.

In a stark contrast, the Hungarian state solved the financial appetite for capital investments by privatizing domestic dairy processing firms and transferring them in bulk to MNCs. In other words, by selecting different methods for solving the problem of undercapitalization, Poland and Hungary also selected widely different modes of transnationalization for their sectors. The Polish strategy - although relying on aid and structural adjustment loans instead of public foreign debt - in many ways mirrors the “traditional”, autonomist developmental strategy of 20th century late industrializers. On the contrary, the Hungarian strategy closely followed Amsden’s “integrationist” model - relying on MNCs for accessing financial capital and technology, in the hope that through horizontal and vertical spillovers, they would upgrade the sector’s overall competitiveness and domestic capacities. It is clear that the Polish model fared substantially better both in upgrading the competitiveness of the domestic dairy sector on transnational markets and in securing the position of domestic dairy producers and processors.

Different public policy choices for reforming property rights institutions

The second, and largely related dimension where public agency proved crucial rested with the state’s ability to shape and reform property rights institutions. Poland chose to keep dairy cooperatives inherited from the Socialist era, where farmers-producers also owned directly processing plants. The state enacted new legislation in 1991, which enshrined dairy cooperative ownership as a legitimate form of private property in spite of pressures from creditors such as the World Bank to push privatization ahead and dismantle collective forms of ownership inherited from Socialism. In contrast, the Hungarian state restructured entirely both the production and the processing segment of its dairy industry: producer cooperatives were sacrificed on the altar of re-privatization, which led to a fragmentation of agricultural land property. On the other hand, the state severed the pre-existing ties between dairy processing plants and their local network of cooperative suppliers by transferring the ownership of processing plants to the State Asset Management Agency (AVU), which in turn was tasked with selling these assets, so that by the end of the 1990s, virtually the entire processing segment of the sector was foreign-owned. Put differently, while the Polish state’s privatization agenda sanctified an inclusive form of domestic ownership in an

institutional format where the production and processing segments were integrated within the same firms, the Hungarian state on the contrary dissociated production from processing: by fragmenting land ownership and encouraging a rapid transfer of ownership from domestic public to foreign private hands, the Hungarian privatization scheme created exclusionary property rights institutions from the perspective of domestic actors. This fundamental difference should naturally be put in light of different strategies at raising foreign capital for financing the investment needs of domestic dairy firms as we discussed previously.

Polish autonomist developmentalism and Hungarian integrationism fared very differently: while the Polish strategy was able to overcome economic backwardness in a relatively inclusive way, the Hungarian pathway not only discriminated against domestic actors, but also largely failed at engineering upgrading. The Hungarian state's later use of increasingly protectionist regulations against MNCs thus reads as an explicit recognition that the integrationist pathway proved to be a developmental failure. Nonetheless, regulatory activism remains a "low-cost" developmental strategy, which still refrains from undertaking the costly investments that the Polish sector had long carried out.

Why the trajectories diverged: state and non-state actors' resources, organization and linkages...and institutional legacies

These policy choices didn't occur in a vacuum: diverging public developmental policies merely reflected different combinations of the three core variables identified by Evans, namely (1) state capacities and the sector-level organization of the state, (2) non-state actors' capacities and their organization at the sector level, as well as (3) state-non-state relations between these two types of actors. What is more, in the second chapter we complemented these variables with the role of historical institutional legacies in the *longue-durée* as a scope condition for the emergence of different developmental models.

In Poland, the emergence of a developmental coalition between state and non-state actors was an outcome of a fundamentally different configuration between specific public administrations and farmers than in Hungary. In the former, the Ministry of

Agriculture (soon followed with FAPA and ARMA) was the decisive public actor, which determined public policy in the restructuring phase. In Hungary on the contrary the divorce between the Ministry of Finance and the Privatization Agency in charge of the processing sector on the one hand, and the Ministry of Agriculture in charge of producers on the other – created a fragmented state apparatus, with competing interests. Furthermore in Poland, the emerging developmental coalition was sustained by farmers who could count on a stable and inclusive property right regime that strengthened their resources, while in Hungary, the fragmented state's privatization agenda virtually cancelled out from the beginning the emergence of a developmental coalition by dealing a fatal blow both to the economic interests and the political representation of farmers. It would take another two decades before some form of developmental alliance emerged between state and domestic non-state actors. While in Poland development was co-produced by the state and farmers, in Hungary the lack of internal coherence within the state soon translated into the sector's own fragmentation.

Importantly, different experiences of collectivization under Socialism proved to have long-term effects: while Hungary managed to nationalize dairy cooperatives in 1948, in Poland the state was forced to retrocede the ownership of processing plants to cooperatives in 1957 in the face of overwhelming resistance from society. Until 1989, this difference was not fundamental, since the actual autonomy of cooperatives under state Socialism was still limited. However, differences in ownership became salient overnight in 1989, when both states were tasked with solving their primary macroeconomic problem – managing foreign debt. The fact that a segment of the Hungarian state could dispose over these assets without resistance from farmers largely explains why the Ministry of Finance included dairy processing plants in the first group of state-owned assets to be sold in 1993. It has to be mentioned also that Hungary's democratic governments prided themselves on repaying foreign debt contracted under Socialism, while Poland managed to secure a massive debt restructuring from its creditors. Whether that option would have been available to Hungary is another question, what remains is that the two successive debt forgiveness programs negotiated by Poland in 1991 and 1994 also eased the pressure on the state to fast-track privatization at all costs: *“In particular, while negotiated debt rescheduling and relief initially offered Poland to consider a national capitalist path of transformation, Hungary*

barely had the same option and essentially adopted foreign-led capitalism from the start. (...) Thus, foreign debt and its management appeared among the main determinants of Hungary's strong export orientation and policy of privatization through massive direct sales to foreigners. At the same time, its reliable debtor status made Hungary an attractive location for FDI" (Bohle & Greskovits, 2012, p.143).

However, we don't embrace a deterministic view: developmental pathways and outcomes are not over-determined by a fixed set of institutional determinants. The opportunity structure for public developmental agency is shaped in part by institutional legacies - some obvious, others more paradoxical: who could have predicted that a deeper degree of Sovietization in Hungary would have given more ammunition precisely for disintegrating public and collective ownership after 1989? Or conversely, that in Poland where cooperatives represented a form of resistance against state ownership in the 1940s, they would be praised for their socially inclusive traits in free markets? Borrowing from the work of Orion A. Lewis and Sven Steinmo, (2012) we see public developmental agency and institutional legacies as co-extensive evolutionary forms.

The fact that in Poland the state did not directly own processing facilities certainly hindered disintegration, but it was not a sufficient, nor a predictable condition for explaining efficient and inclusive modernization. We cannot generalize from a comparative study of two cases, and thus we would refrain from arguing that farmer ownership over the vertically integrated supply chain is a necessary condition for efficient co-produced upgrading, nor that state ownership in Hungary could have predicted the ensuing debacle: all we can say is that it was a scope condition, which weakened the coherence of a public developmental roadmap in Hungary – while it contributed to maintaining it in Poland.

Part 3. Contributions

Diverse developmental pathways at the sector level in Visegrad countries

At a most basic level, this thesis sought to stress that there is a substantially greater scope for variation in modes of transnationalization for developing economies than what

is usually assumed. Faced with the same problems, similar developing- or transition-economies can – and empirically do – embrace different pathways for integrating transnational markets, each having different developmental costs and benefits. We are very much cognizant of this work's limitations: no robust theory can come out of a comparative framework focusing on merely two cases in a sector such as dairy. However, even within this modest scope, we would argue that more sector-level comparative work would be beneficial for testing the real plurality of transnational integration modes, which might characterize developing economies: Julia Langbein (2015) has for instance studied different sub-national modes of transnationalization within different sectors in Ukraine under the dual pressure of Russia and the EU. However, she has done so from the perspective of regulatory integration – while it could be also stimulating to study potentially diverging developmental outcomes between individual sectors of a developing economies.

We have argued that there is *a priori* a greater scope for variation in modes of transnationalization – and the developmental consequences thereof – in less technology-intensive sectors, than in high-tech ones where proprietary technology belonging to MNCs doesn't offer many alternatives for late-industrializers. It could also be interesting to study the coordination – or lack thereof – between integrationist and autonomist sectors of a single economy from a developmental perspective: for instance what is the political economic relevance of a co-existing *re-domestication* in Hungarian food processing- or retail sectors all the while the most important sector for the country's GDP – automotives – continues to depend entirely on foreign capital?

Illiberal democracy as an answer to the developmental failure of integrationism?

This thesis also speaks to a broader debate regarding convergence and divergence within CEE. Most students of post-Socialist CEE agree that different attempts at building a national variety of capitalism could be observed throughout the region at the very onset of transition in 1989-93, - models characterized by domestic ownership and often mobilizing the social capital and networks of the former nomenklatura (Drahokoupil, 2009). This often manifested in early and unregulated privatization schemes where state property was massively transferred to a complex alliance composed of party

apparatchiks and the managers of conglomerates and cooperatives. In Hungary, this phenomenon was called “spontaneous privatization” and it actually started slightly before the official collapse of state Socialism, but the seminal work of Szelényi, Eyal and Townsend (1998) also identified a similar pattern in Poland and the Czech Republic. However, with the partial “anomaly” of Slovakia’s Meciar who tried to advance in this direction until 1998, these models were generally quickly abandoned: after 1993-95, most CEE countries chose to privilege foreign investors – primarily MNCs – for restructuring remaining Socialist firms in a number of crucial sectors. The consolidation of FDI and foreign ownership were the results of this second period of privatization. Drahokoupil (2009) argues that the original alliance of domestic actors – party apparatchiks and managers – was in fact replaced by a second strategic coalition composed of a fraction of the former *nomenklatura* that already had international contacts throughout the 1980s and quickly capitalized on these networks in the early 1990s: teams of negotiators within ministries that struck deals with the Bretton Woods organizations, high-level bureaucrats within the national privatization agencies etc. According to them, this relatively small pool of domestic actors, with strong links both in the former one-party system and with international organizations successfully entered new alliances with their former foreign partners – IFIs, foreign creditors, consultancies and MNCs – at the onset of the crucial reversal in privatization strategies. They call the emerging coalition the “comprador service sector”, and fundamentally derive the transnationalization of CEE economies through FDI – in other words the transformation of CEE into “dependent market economies”, with the interest-motivated agency of these networks: foreign public and private actors prospecting the post-Socialist markets for potential investments among the ruins of the Socialist economies - and a new domestic élite who saw a new opportunity in facilitating FDI as a way of strengthening their economic and political position. It seems that the bulk of the scholarship has until recently considered this story closed: foreign ownership as well as the potential interest coalitions that had originally enabled it have been assumed stable and cemented in CEE economies.

By contrast, the Hungarian pathway in the dairy sector shows that alliances as well as the very mode of transnationalization through FDI might be substantially more fragile or transient than previously assumed. At the sector level in Hungary, the emergence of new

types of coalitions between the state and an emerging national bourgeoisie with stakes in the processing and retail sectors - has indeed replaced the previous alignment of interests. We believe that modestly as it may be, the present work might also contribute to shedding light on seemingly surprising transformations that characterize the current Hungarian regime: one that claims to cancel out dependency on MNCs but also to replace “imported” ideals of liberal democracy – with a new political economy characterized by domestic ownership (in particular sectors) as well as a “labor-based economy”. In fact, a particularity of Hungary’s new, „illiberal” model is that crucial industrial sectors such as automotive remain entirely foreign-owned, as domestic actors simply don’t dispose of the human capital necessary for replacing the know-how of German car manufacturers. Integrationism, or hyper-integrationism as termed by Scepanovic – is not (and cannot be-) questioned in technology-intensive sectors. However, in a number of other economic sectors, which rely more on financial capital than proprietary technologies, the state clearly aims at building on a new nationalist coalition meant to curb MNC ownership: food processing, retail – but also segments of banking fall in this latter category. An aggressively nationalistic narrative, which is supposedly at loggerheads with MNCs – in fact tolerates and even encourages foreign investments in industrial sectors where the lack of domestically engineered innovation prevents an autonomist strategy. In parallel however, the „struggle for sovereignty” is carefully staged in sectors such as food processing and retail. These dynamics can be captured at a micro-level in the transformations characterizing the public re-regulation and the re-domestication of the Hungarian dairy sector. In fact the empirical description of the sector’s trajectory also sheds light on the inconsistencies or cynical omissions that sustain this new regime: most notably a strategic manipulation of narratives concerning the exploitation of domestic actors (in this case farmers) by foreign capital – a trope used to legitimize increasingly adversarial forms of regulations towards MNCs under the pretense of establishing a more inclusive developmental model. As described previously, this narrative is misleading in as much as farmers continue to be marginalized and the state doesn’t display any more appetite for strengthening their competitiveness, upgrading their capacities and fostering new forms of institutional representation for their interests than in the preceding period. The real winners of the new era are a handful of capital-rich domestic companies at the processing and retail level with strong connections to the government party. This divorce between a nationalist developmental

narrative and the empirical reality of a continued marginalization of vulnerable domestic actors is prevalent throughout the economy well beyond dairy.

As such, Hungary's new political economic system doesn't actually attempt at redressing the shortcomings experienced by an overly integrationist developmental strategy, which is bound to hit the glass ceiling of a middle-income trap: investments in human capital remain minimal. Similarly, while integrationism did in fact marginalize particular domestic groups such as farmers-producers – their plight is used as a narrative device, meant to legitimize a re-domestication of property rights, which is not substantially more inclusive than transnational integration through FDI.

These dynamics could be understood as the Polanyian motion of a pendulum oscillating between the forces of market autonomy and those pushing toward the social re-embedding of markets: this was the theoretical framework in which Bohle and Greskovits (2012) described CEE economies. In short, the current Hungarian model might be understood as an attempt to check some of the most patent shortcomings of integrationism, and it may translate a desire to re-embed market forces in society.

However, this model seems more preoccupying: Firstly, as briefly described above, it doesn't provide solutions to the crucial problems of integrationism – namely the marginalization of domestic firms to the benefit of MNCs, and the developmental glass ceiling of a middle-income trap resulting from a lack of endogenous innovation. Instead, it perpetuates these deficiencies – which it seeks to conceal by building on aggressive forms of nationalism. The second reason for concern is that a large body of scholarship seems to indicate that the developmental shortcomings of integrationism are increasingly obvious: short-term gains in export revenues, wages or employment are more than offset by the marginalization of domestic actors and a lack of technological spillovers (Baldwin, 2013; Jacoby, 2010; Scepanovic, 2013). Giant emerging economies such as China, India or Brazil might use market access as a bargaining chip for building stronger linkages between MNCs and domestic sectors (Scepanovic, 2013, p.194). For smaller developing economies however, the regulatory tools of the state might only attempt at curbing MNC market shares – as occurred in Hungary. Even that requires

some degree of Weberian competence on the part of the state, and a minimal degree of autonomy from MNC interests, which might be available to Hungary but in short supply in LDCs. As the developmental trap of integrationism is becoming ever more manifest, the danger is that transition- and developing economies that had embarked on integrationist strategies since the 1980s might opt for chaotic policy re-orientations that combine the worst of both worlds: it is conceivable that Hungary's current experiment in "illiberalism" might become an appealing model in CEE and beyond.

The relevance of dairy for re-evaluating the developmental role of low-tech sectors

Besides the descriptive nature of a relatively under-studied industrial sector, the question is what the present case study adds to existing theories of developmental pathways in CEE and potentially beyond, in peripheral and semi-peripheral economies: What is the dairy sector really a case of? In that regard, we would argue that a substantial part of the current literatures on economic development is focused on high-tech sectors, while less technology-intensive sectors have received less attention: agriculture and agri-food for instance are thus often implicitly tied to the question of food security for LDCs – as if less technology-intensive sectors were the sole concern of the poorest economies and a matter of physical survival rather than part and parcel of sustainable and diversified economies. In our view this reflects a positivistic bias, which doesn't reflect the opportunities – or even the long-term needs of smaller developing economies: the assumption that high-tech stands for high growth and fully "modern" ought to be fundamentally questioned. Case studies in high-tech industrial sectors converge on the problem of proprietary technologies inhibiting technology transfers – a fact adamantly demonstrated by Scepanovic in relation to CEE automotive sectors. In this game, it should be clear that smaller economies cannot all replicate India's or China's successful conversion into technology powerhouses: thus, low-tech sectors are bound to remain an important part in the industrial structure of smaller peripheral and semi-peripheral nations. Neither would it be desirable if less technology-intensive sectors were considered as antiquated relics: they continue to be important employers of a domestic workforce, which cannot realistically be absorbed by high-tech industries – especially not when the rules of the game actively prohibit smaller developing economies from building their own innovation feedback loops. Spurring innovation and

investments in human capital are rightly considered crucial developmental objectives, but rather than betting everything on high-tech, the place of less technology-intensive sectors should in our view be re-evaluated when thinking of sustainable developmental pathways. Upgrading in less technology-intensive sectors seems just as vital as (attempting to build) high-tech. This is a fact, which fortunately begins to permeate the mindset of transnational developmental organizations as well, as demonstrated for instance by the findings of the EU's 5th Framework Program on innovation: *"Low-tech and medium-to-low-tech (LMT) industries in the OECD countries employ many more people than high-tech industries. Moreover, many firms in these industries are innovative and knowledge intensive without, by definition, engaging in R&D to any great extent. Thus, they provide a striking challenge to currently held notions about the sources of future industrial growth. Our analysis suggests that while new sectors emerge within the economy, and some sectors disappear, this does not account for the processes of growth, which actually occur across the OECD. The growth trajectories of the advanced economies seem to rest as much on such sectors as engineering, food, wood products, and vehicles and so on, as they do on such sectors as ICT or biotech. Medium-low and low-tech industries have persisted over the past decades despite the claims that we are undergoing a kind of structural revolution. In terms of industrial structure, change and growth, there is substantial variation across OECD countries when it comes to the shares of output and employment accounted for by high-tech industries – there are quite different sectoral mixes that persist over time. In this context we found no evidence of any direct linkage between technological intensity of the industrial structure and economic growth at the level of the economy as a whole. There is no simple relationship to the effect that the high-tech economies are also the high growth economies. This suggests that different economies can follow different routes to economic growth. Countries play different roles in an economic system which is differentiated at the international level, and in which there is a division of labour among the highly developed economies. These research findings show that growth is primarily based not on the creation of new sectors but on the internal transformation of sectors that already exist. Overemphasising the role of high-tech activities ignores this major dimension of change in advanced economies. As a corollary, in order to ensure continued future growth prospects for advanced economies, policy-makers need to focus on the processes of innovation and creativity in firms in all sectors, not just high-tech firms"* (European Commission DG Research, 2006, p.13).

From this perspective, the experience of the Polish dairy sector's successful post-Socialist upgrading in particular might justify a degree of optimism: as the developmental glass ceiling is substantially thinner in less technology-intensive sectors, there is reason to believe that inclusive economic upgrading is equally (relatively) easier to attain than in high-tech sectors.

What is more surprising is that Poland's successful upgrading strategy largely relied on the "protection and promotion" toolkit used by "traditional", autonomist developmental states – as described by Evans or Amsden. In light of a host of reasons underlined in chapter one – among which the timing of transition, the role of foreign capital and externally-steered institutional change by the EU – post-Socialist CEE struggling to avoid a general economic collapse during the 1990s is arguably one of the least likely candidates for observing the persistence of 20th century developmental public policies... Yet this is precisely what happened: a *sectorial* developmental state in a (neoliberal) context where it wasn't supposed to exist. Without overstressing the argument, we would argue that the pathway of Polish dairy testifies of a substantially larger room for public developmental maneuvering in less technology-intensive sectors where technology can be purchased for the most part - than in high-tech sectors where the structural lack of financial capital is aggravated by a lack of domestically owned- and engineered- innovation.

The present thesis sought to demonstrate that there is indeed a strong relevance for complementing preexisting sector-level case studies in high-tech sectors with less capital-intensive ones such as dairy: Not only because these sectors continue to matter *a priori* even in core capitalist economies, and far from relics, are actually vital for smaller developing countries – but also because they shed light on certain developmental aspects of transnational economic integration in CEE (and beyond potentially), which might otherwise be overlooked. We would like to emphasize two points in that regard: Firstly, the degree of heterogeneity characterizing developmental pathways among similar, small developing- and transition economies caught in deeply transnationalized markets, and second, the transient, evolving nature of these pathways.

Modes of transnationalization in high-tech sectors appear relatively uniform across the CEE region and Visegrad countries in particular: it seems virtually impossible to shed integrationism or hyper-integrationism for alternative strategies given the lack of endogenous innovation. The developmental outcomes thereof are equally similar across the region: short-term gains - yet a very real danger of digging oneself in a middle-income trap. However, when studying less capital-intensive sectors such as dairy, which offer theoretically a wider scope for different policy choices, one might genuinely be surprised by the empirical diversity of transnationalization modes not only at the intra-regional but also at the sub-national (sector) level. It seems to us that neither the early 1990s literatures on privatization, nor the later typologies developed in reference- or in reaction- to the VoC agenda fully account for this diversity, which is worth exploring, for one can grasp counter-intuitive processes along the way: for instance and as mentioned above, the fact that “traditional” protection and promotion policies are alive and kicking in some low-tech sectors – in other words that the classical toolkit of the autonomist developmental state can survive in the neoliberal era even in smaller developing economies - albeit constrained to low-tech.

A second important element is that in these sectors, there doesn't seem to be a developmental lock-in: the VoC literature for instance displays a rather schematic periodization of developmental strategies in CEE, where early attempts at building national forms of capitalism were swiftly replaced with more FDI friendly strategies. As the present case study shows, while early choices - such as managing privatization - proved tremendously consequential, *lock-outs* from a certain developmental pathway do exist: the belated emergence of a developmental coalition in Hungary between state- and non-state actors shows that in low-tech sectors at least, it remains possible to abandon an inefficient developmental model and explore alternatives (notwithstanding the developmental efficiency of newer strategies). In other words, developmental pathways are not only more diverse in low-tech sectors such as dairy, but they are also fundamentally dynamic and transient.

List of Interviews

- 1.) Zoltán Gyaraky, Head of Food Processing Section at the Hungarian Ministry of Rural Development, Budapest, 07/10/2013
- 2.) Péter Tóth, CEO of Hungarian Private Agricultural Consultancy Agrár Európa Kft., Budapest, 12/11/2013
- 3.) Zoltán Fórián, Dairy sector expert and agricultural economist at Hungarian Private Agricultural Consultancy Agrár Európa Kft, agricultural economist, Budapest, 12/11/2013
- 4.) Folláth Györgyné, Secretary General of the Hungarian Union of Food Processors (EFOSZ), Budapest, 22/11/2013
- 5.) Gábor G. Szabó, agricultural economist and cooperative expert at the Hungarian Institute of Agricultural Economics (AKI), Budapest 03/10/2013
- 6.) Anikó Juhász, agricultural economist and agricultural development policy expert Hungarian Institute of Agricultural Economics (AKI), Budapest, 01/10/2013
- 7.) Attila Jámbor, agri-food trade expert, Corvinus University, Budapest, 17/09/2013
- 8.) Ádám Lendvai, Manager of the National Supplier Program at Tesco Hungary, Budapest, 05/11/2013
- 9.) Tibor Mélykúti, CEO of Alföldi Milk, Székesfehérvár, 01/12/2013
- 10.) Attila Kecskeméti, CEO of Hungarian Branding Company (Magyar Termék), Budapest, 26/09/2013
- 11.) László Lukács, Head of the Hungarian Milk Council, Budapest, 13/10/2013

- 12.) Grzegorz Anczewski, FAPA-MARD liaison, Warsaw, 20/02/2014
- 13.) Polish Association of Dairy Cooperatives (KZSM), Warsaw, 11/02/2014
- 14.) Bugala Adam, statistician and agri-food trade expert at FAPA, Warsaw, 04/03/2014
- 15.) Jan Falkowski, economist at the Polish University of Economics, agri-food sector expert, Warsaw, 03/02/2014
- 16.) Agnieszka Maliszewska, Director of the Polish Chamber of Milk (Polska Izba Mleka), Bialystok, 06/03/2014
- 17.) Marcin Hydzik, Head of the Association of Polish Milk Processors (ZPPM), Warsaw, 11/03/2014
- 18.) Ewa Domanska, Polish Ministry of Agriculture and Rural Development (MARD), Head of Milk and Dairy Sector, Warsaw, 25/02/2014
- 19.) Zbigniew Florianczyk, dairy sector expert at Polish Institute of Agricultural Economics (IERIGZ), Warsaw, 13/02/2014
- 20.) Jadwiga Seremak-Bulge, dairy sector expert at Polish Institute of Agricultural Economics (IERIGZ), Warsaw, 20/02/2014
- 21.) Barbara Kucharska, Head of Documentation Services at FAPA, Warsaw, 21/02/2014
- 22.) Agata Nowinska, FAPA Deputy Director, Warsaw, 21/02/2014
- 23.) Anonymous, trade manager at Polish Dairy Cooperative Spomlek, Warsaw, 7/03/2014

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